FEDERAL FINANCIAL RELATIONS IN INDIA

FEDERAL FINANCIAL RELATIONS IN INDIA

RAMAN BOMBWALL

MEENAKSHI PRAKASHAN
BEGUM BRIDGE MEERUT

MEENAKSHI PRAKASHAN
Begum Bridge
Meerut

Printed at
Prakash Printing Press, Meerut

PREFACE

THE PRESENT STUDY makes an attempt on the Union-State financial relations in India with particular reference to the role played by the Finance Commission. The Constitution of India can claim the distinction of having made elaborate provisions for ensuring both adequacy and independence to the States in the sphere of finance. Since it was realized by the constitution-makers that the constitutional division of financial resources would leave the States in a position of relative financial inadequacy, provision was made for a Finance Commission, an independent agency entrusted with the task of removing this inadequacy without compromising State autonomy. It has been the author's aim to enquire into the actual working of Union-State relations in India over the past two decades and to examine the factors which have caused and accentuated the imbalance of resources as between the Union and the States and have prevented the Finance Commission, an institution which has been aptly described as India's major contribution to the theory and practice of federalism, from playing effectively the role envisaged for it by the framers.

It is axiomatic that financial relations between the general and regional governments in a federation provide the key to the actual equation between the two levels of government in the legislative and administrative spheres. It is for this reason that a study of federal financial relations in India is of paramount importance for a proper understanding of the working of our federal polity. Strangely enough, this field of enquiry has been almost exclusively the preserve of economists. As far as is known to the author, the present study is the first to approach the problem from the standpoint of political science.

The study has been based on primary sources such as the relevant reports of Constituent Assembly Debates and reports of the four Finance Commissions. However, extensive use has also been made of standard secondary works on federal relations in general and federal financial relations in particular.

I am deeply indebted to Dr. K. R. Bombwall, who allowed the use of his personal library and patiently discussed the numerous problems. My particular thanks are due to Dr. R. Argal, without whose encouragement this work could not have been completed.

RAMAN BOMBWALL

CONTENTS

CHAPTER 1

PROBLEMS OF FEDERAL FINANCE

INTRODUCTORY

FINANCE provides the back-bone and sinews of government. Indeed, no government can carry out its responsibilities without money and the degree of efficiency with which it meets its obligations and the measure of its success in satisfying the expectations of its people in regard to services depend largely on the adequacy of its financial resources. Finance, as Wheare has put it, 'is an essential pre-requisite of government'.[1] Roy Blough says: 'The stubborn fact that government and the services of government are possible only if they can be paid for, makes finance one of the central factors determining the success or failure of a federal system of government as well as any other governmental system'.[2] According to S. P. Aiyar, 'so fundamental is money to government that one might redefine the orthodox constituents of the state by saying that it consists of territory, people, sovereignty, organization and financial resources'.[3] This is so whether the form of government is unitary or federal. Besides, certain general problems of public finance, such as the problem of maintaining a proper balance between taxation and borrowing on the one hand and between direct and indirect taxation on the other and the problems relating to currency control, central banking, appropriations, audit and sinking fund are common to all governments whatever their forms.

However, important as finance is in all governments, its role is pivotal in a federal state. 'It is a truism as old as Justice Marshall that in a federation the crucial power is the power to tax.' 'Like a potent magnet it draws to itself the other elements of real

[1] K. C. Wheare, *Federal Government*, London, 1956, p. 97.

[2] Carl J. Friedrich and Robert R Bowie, *Studies in Federalism*, Boston, 1954, p. 385.

[3] S. P. Aiyar, *Federalism and Social Change*, Bombay, 1961, p. 32.

sovereignty.'[4] Accordingly, there are certain special problems of public finance which pertain to the federal state.

The essence of a federation is that the general and regional governments should be more or less independent of each other in their respective, constitutionally demarcated, spheres of action. To ensure this mutual independence, it is necessary that the division of legislative functions laid down in the constitution should be accompanied by a corresponding allocation of financial resources, and the guiding principle of this demarcation has to be that each level of government should have at its disposal adequate financial resources to discharge the functions assigned to it. Consequently, 'the most important problem of federalism is that of finances, of the raising of revenues wherewith to pay for the various functions of the various levels of government'.[5] Stating the position in accordance with his rigid definition of the federal principle, Wheare has observed: 'Both general and regional governments must each have under its independent control financial resources sufficient to perform its exclusive functions. Each must be financially co-ordinate with the other'.[6] This is so because financial independence is, in fact, the back-bone of the autonomy of regional governments in a federation. It may be noted here parenthetically that this absolute mutual independence and co-ordinate status as between the general and regional governments have not been achieved in any federation.

Alexander Hamilton, one of the fathers of the American constitution, stated the principle underlying financial relations between the national and local governments in a federation in the following words: 'It is as necessary that the state governments should be able to command the means of supplying their wants as that the national government possess the like faculty in respect of the wants of the Union'.[7] In short, the first peculiar problem of federal finance is that of matching functions with resources, that is 'of securing equilibrium between the division of constitutional powers and the division

[4] Alexander A. Brady, *Democracy in the Dominions*, Toronto, 1948, p. 150.

[5] Carl J. Friedrich and Theodore S. Baer, in *Studies in Federalism* (edited by Carl J. Friedrich and Robert R. Bowie), *op. cit.*, p. 358.

[6] K. C. Wheare, *op. cit.*, p. 97.

[7] *The Federalist*, xxxi, p. 149.

of revenue resources'[8]. For one thing, the resources at the disposal of each level of government should be adequate *i.e.*, commensurate with the scale of activities entrusted to it. For another, each level of government should be independent of the other in raising and spending its revenues. 'The integrity of the financial system in any federation', writes Aiyar, 'may be tested by a double criterion. On the one hand it must ensure independence. On the other hand it must be adequate'.[9] In practice, however, these principles of an ideal distribution have not been observed anywhere, least of all in the older federations. The chronic gap between their expenditure potential and their 'independent' financial resources is a feature that marks the component units of every federal state.[10]

II

Another peculiar problem of federal finance arises from the fact that the balance between functions and resources, as originally established in the constitution, tends to be distorted by subsequent economic social and technological developments. This distortion of the original equilibrium and the widening gap between the activities and financial resources of local governments has been particularly marked in older federations such as the U.S.A., Canada and Australia. As Wheare has pointed out, 'functions and resources do not expand or contract together each adjusting itself harmoniously to the other'.[11] The general trend in federal states has been towards a relatively greater expansion in the financial resources of the national government with the result that the component units tend steadily to lose not only the adequacy but the independence of their means. The growth of the welfare state has considerably increased the demands on the resources of the states. Their tax powers, on the other hand, are limited partly by the constitution and partly by the realities of the situation. Speaking of the United States, Bradley has observed : 'The balance of practical political power and, so, of

[8] A. H. Birch, *Federalism, Finance and Social Legislation*, London, 1955, p. 120.

[9] S. P. Aiyar, *op. cit.*, p. 32.

[10] The case of the United States, where the local governments are financially self-sufficient, is rather exceptional on account of its great riches.

[11] K. C. Wheare, *op. cit.*, p 98.

functional influence and administrative activity, has altered with changes in the economic and social environment'.[12] He has stated further that 'if constitutional aspects of federalism were reviewed in detail, one would discover that economic, social and technological changes and population shifts have underlain the steady accretion of federal power'.[13] As D. R. Gadgil[14] has pointed out: 'At the inception of the federal states, a conscious attempt is usually made to match the functions of each authority with the resources required to fulfil them. However with the passage of time there would be no guarantee that the expansion of responsibility due to a widening interpretation of functions would correspond closely with the elasticity of the allotted sources of revenue. Moreover, the modern trend towards greater political and economic integration requires acquisition of over-all powers by the general government in many respects, including some aspects of fiscal operation.'

The older federations were established in the era of the negative or 'minimal' state and constitutional provisions were shaped by the current limited conception of the ends and activities of government. In Canada, for instance, the constitution-makers presumed that 'direct taxation within the province in order to the raising of a revenue for provincial purposes',[15] would be quite ade-

[12] Phillips Bradley, 'Inter-Government Relations in the United States'. *The Indian Journal of Public Administration*, Vol. III, No. 4, October-December, 1957, p. 372.

[13] *Ibid.*, p. 373.

[14] D. R. Gadgil, *Planning and Economic Policy in India*, Bombay, 1965, p. 294.

Cf. D. T. Lakdawala: 'Extension of social welfare measures and the greater role of the State in development have increased expenditures of the regional layers, whereas greater integration of the national economy and the understanding and appreciation of functional finance have led to more progressive taxes being left at the national level. It is this difficulty that constitutes the additional financial problem in a federal set-up.' *Union-State Financial Relations*, Bombay, 1967, p. 3.

[15] Other sources of provincial revenue are, receipts from the public domains, license and other fees and subsidies payable by the federal government. In the case of Canada it is well to recall that the independence of the provinces in financial affairs is limited always by the fact that, as a matter of law, the Dominion Government may disallow acts dealing with financial as well as other matters. In practice, this power has not been exercised in regard to budget legislation.

quate for enabling provincial governments to meet their requirements of law and order and their minimal commitments in respect of social services. This explains why the provinces were, so to say, put on a rigid allowance. As W. A. Mackintosh has put it, 'it seems to have been somewhat on the stern model of a somewhat unreliable young man being given a not too generous allowance with the warning that, if he is extravagant, he must go to work to acquire the extra funds'.[16] The attempt was clearly to curb a tendency to incur too much expenditure on such activities as education, public health etc. 'If the men in power', said A. T. Calt, one of the chief financial architects of the Canadian constitution, 'find that they are required by direct taxation to procure the funds necessary to administer the local affairs for which abundant provision is made in this scheme, they will pause before they enter on any career of extravagance'.[17]

Later developments have shown how mistaken the framers of the Canadian constitution were and how little foreknowledge they had of the increase in the cost of education, highways, health and welfare and unemployment relief, all falling within the constitutional responsibilities of the provinces. Besides, Canada—like all other countries—has moved into the era of the positive state. The combined effect of these developments has been a significant expansion of the social service activities of provinces without a corresponding expansion of their constitutionally prescribed sources of revenue. If anything, the financial powers of the provinces have in practice been whittled down. On the contrary, the financial resources of the Dominion government have grown quite considerably although its constitutional responsibility in regard to social services and welfare activities has, by and large, remained unchanged. Over the years, therefore, an anomalous situation arose and became particularly marked during the depression of the nineteen-thirtees. 'The provincial governments had the constitutional right but not the financial capacity to deal with the social and economic crisis. The Dominion government had the financial ability but not the legal

[16] 'Federal Finance', in Geoffray Sawer (ed.), *Federalism, An Australian Jubilee Study*, Melbourne, 1952, p. 86.

[17] *Ibid.*, pp. 86–87.

right to undertake responsibility'.[18]

The great change that has occurred may be illustrated by an example. In 1874, the total expenditure incurred on education by all the provincial governments amounted to 4 million dollars. In 1937, the expenditure had risen to 250 million dollars, that is, sixty times in almost as many years.[19] Inevitably, the situation has affected the Dominion-Province equation to the serious disadvantage of the provinces. To meet their ever-rising financial burdens, provincial governments have had to depend increasingly on the Dominion government for grants and subsidies. As a natural consequence, there has been steady erosion of their autonomy. There is substantial truth in the view that today 'there is actually little to distinguish the position of Canadian provinces from that of the regions of a unitary state'.[20]

What has been said of Canada is true in varying degrees of Australia and the United States also. In Australia, the financial balance of power was *ab initio* tilted in favour of the Commonwealth. The balance has since been progressively shifting to the disadvantage of the states. The establishment of the Australian Loan Council in 1928 adversely affected the financial competence of the states which by a self-denying ordinance surrendered their independent power to borrow. The Australian High Court's judgement in the *Uniform Tax Law Case* in 1942, settled beyond doubt the Commonwealth's power to exclude the states from the field of direct taxation. The autonomy of the states is apparently safeguarded by the constitution, but in fact, it has been considerably diluted. This has largely been the result of their lack of financial adequacy. Their growing responsibilities in respect of social services and welfare activities have forced them to depend increasingly on financial assistance from the Commonwealth government. Some idea of this growing dependence may be had from the fact that while in 1942–43 Commonwealth grants to the states amounted to £ 2,000,000, in 1950–51 the amount had risen to £ 12,000,000. The position today, therefore, is that though the states are legally free,

[18] S. P. Aiyar, *op. cit.*, p. 116.

[19] R. M. Dawson, *Democratic Government in Canada*, Toronto, 1949, p. 33.

[20] S. P. Aiyar, *op. cit.*, p 130.

financially they are bound to the chariot wheels of the Commonwealth government.

The experience of older federations has shown, as Wheare points out, that it is not possible to lay down finally, in a federal constitution, the division of financial resources between the federal and regional governments and 'there should exist machinery for adjustment and re-allocation in the light of changing conditions'.[21] Since the problem of federal finance is 'that of maintaining, through changing circumstances, needed correspondence between functions and resources without the use of coercive power',[22] there has been a marked tendency in federal constitutions to avoid rigidity in the division of powers and finances. The tendency is revealed in the provision of concurrent powers and the institution of balancing devices such as tax sharing and federal grants (conditional and unconditional) to the regional governments. Since the gap between the functions and resources of regional governments varies from time to time, balancing devices have, of necessity, to be of a flexible nature. In many of the older federations, such devices are formally provided for in the constitution. Actual experience has shown, however, that the sharing of tax revenues and the disbursement of federal grants to the states are often subject to political pressures and bargaining. The Indian constitution has the distinction of providing balancing mechanisms in the shape of tax sharing and central grants-in-aid to states under Art. 275 which are worked on the recommendations of an independent expert agency (the Finance Commission) and thus removes these operations from the arena of politics.

III

Apart from the general problems of federal finance relating to the difficulty of securing a satisfactory equilibrium between the division of constitutional powers and the allocation of revenue resources and, further, of mitigating the effects of the distortion of the original federal-state financial equation, there is yet another problem characterising financial relations in a federal state. This problem arises because in every federal state some component units are poorer than

[21] K. C. Wheare, *op. cit.*, p. 123.

[22] D. R. Gadgil, *op. cit.*, p. 293.

others. The units stand at different levels of economic development and are differently endowed with natural resources. The resulting variations in financial capacity and standards of economic development are the outcome of natural and historical factors. In a federal set-up they are likely to be accentuated since every constituent unit is supposed to raise its own revenues to cope with its constitutional responsibilities which, however, are alike for all units.

The gap between constitutional responsibilities and financial resources is bound to result in disparities in the standards of social services and administrative efficiency among the units. In all federations, devices are developed for reducing these disparities as far as possible. Usually, these devices take the form of federal grants-in-aid to the units, grants being varied in accordance with fiscal need. In other words, there is a tendency for federal assistance to be weighted in favour of the poorer and less developed states, the aim being to lessen financial and economic inequalities among the states.

In Australia, a system of special grants to three claimant states (Western Australia, Tasmania and South Australia) has developed under the authority of section 96 of the Commonwealth constitution. Until 1934-35, the grants were determined solely by the Commonwealth Government. Since then, they have been made on the recommendations of the Commonwealth Grants Commission. The purpose of these grants, as one expert has put it, is 'to enable the three claimant states to function at a standard not appreciably below that of the other states.'[23] In Canada the special needs of some of the provinces came to be officially, though partially, recognised during the second World War and Dominion subsidies came to be weighted in favour of the more needy provinces. Dealing with the claims of maritime provinces, the Royal Commission on Maritime Claims (1927) rejected the argument that Dominion grants to provinces should be based on fiscal need but agreed that 'additional' payments to the maritime provinces were justified on the ground that these provinces had 'not shared proportionately with the other provinces of Canada in the economic advantages accruing to the Dominion as

[23] H. P. Brown, 'Some Aspects of Federal-State Financial Relations' in Geoffrey Sawer (ed.), *Federalism, An Australian Jubilee Study*, Melbourne, 1952, p. 52.

a whole from confederation'.[24] In the United States, there has been no separate scheme for financial assistance to the poorer states, although the net effect of the grants-in-aid, when compared with the incidence of federal taxation, is to favour these states. The most interesting development in the federal-state financial relations in the United States since the war has been the institution of variable grants designed to help the poorer states.[25] By these means, says Birch, the nation seeks to remove inequality of financial resources as between the states and the inability of weaker states to maintain the indispensable standards of national efficiency in matters of health, education and the like.[26] In India, the Finance Commission has consistently applied the principle of reducing disparities among states as one of the guiding principles of its recommendations in regard to tax sharing and allocation of grants-in-aids to states.

[24] A. H. Birch, *op. cit.*, p. 121.
[25] *Ibid.*, p. 268.
[26] *Ibid.*, p. 121.

CHAPTER II

EVOLUTION OF FEDERAL FINANCE IN INDIA

1. FINANCIAL DEVOLUTION, 1871–1919

THE financial reforms of 1871 marked a new departure in the development of Centre-Province financial relations. Until then complete financial centralisation characterised the administrative system in India and was a natural concomitant of the absolutely unitarian set-up established under the Charter Act, 1833. Through this measure, the provinces were deprived of the power of legislating for their territories and of incurring the smallest expenditure without the sanction of the Government of India. They were required to obey the orders of the Governor General-in-Council in every particular and to keep the latter constantly and diligently informed of all their proceedings. The detailed and rigid control exercised by the Government of India over provincial finances may be summed up in the following words of two contemporary observers :[1]

> The local governments which practically carried on the whole administration of the country, were left with almost no powers of financial control over the affairs of their respective provinces and no financial responsibility. Every thing was rigorously centralised.... It (the Government of India) controlled the smallest details of every branch of expenditure ; its authority was required for the employment of every person paid with public money, however small his salary ; and its sanction was necessary for the grant of funds even for purely local works of improvement, for every local road, and every building, however insignificant.

The system was highly defective in so far as it divorced administrative responsibility from financial power and thereby encouraged extravagance. The provinces made heavy demands on the

[1] Sir John and Lieut. Gen. Richard Strachey, *Finances and Public Works of India*, 1869-1881, London, 1882, p. 134.

Centre as they were often moved by the genuine necessity of improvement on every side. In distributing funds among the provinces, the Government of India acted on neither rational nor fixed principles. The result was that the distribution of public revenues degenerated into 'something like a scramble in which the most violent has the advantage with very little attention to reason'.[2] Thus, provincial governments subsisted on doles made by the Centre, not always on defined principles. 'The arrangement', as Asok Chanda observes, 'was not only irrational but created many administrative difficulties'.[3]

Such was the legal position. On the contrary, the absence of an appropriate budget and an efficient machinery of audit and accounts rendered the Centre's nominally complete control over provincial finances, in practice, into 'titular authority'.[4] The system set a premium on waste and extravagance. Economies effected by a local government in one direction could not be utilised by it in another without the express sanction of the Centre, while reduction in its expenditure in any year was sure to be followed by a corres-ponding reduction in its share of the imperial revenue in the follow-ing year. As the revenues collected through a provincial agency bore no relation to the revenues allotted to its share, no provincial government was interested in developing them. Thus, 'the centra-lised system of finances gave rise to financial irresponsibility and put a premium on extravagance'.[5] Naturally, there was frequent and strong criticism of this wasteful system. As early as in 1860, General Dickens suggested provincialisation of Indian Finance.

In 1861 Samuel Laing, Finance Member in the Governor General's Executive Council, also proposed a system of provincial finance. These proposals were criticised as inadequate by Mr. Matby, a member of the Madras Executive Council. In 1862, Laing put forward a revised scheme and made out a strong case for financial decentralisation. He declared : 'It is most desirable to break through the system of barren uniformity and pedantic centralisation which

[2] *Ibid.*, p. 137.

[3] Asok Chanda, *Federalism in India*, London, 1965, p. 134.

[4] B. R. Ambedkar, *The Evolution of Provincial Finance in India*, Lahore, 1925, p. 27.

[5] B. R. Misra, *Indian Federal Finance*, Calcutta, 1960, p. 34.

have tended in times past to reduce all India to dependence on the bureaux of Calcutta, and to give to local Governments the power and responsibility of managing their own local affairs'.[6] In 1867 Col. Strachey prepared a plan of federal finance for India which was designed gradually to make the financial position of the Government of India 'similar to that of the Federal Government of the United States of America'. Evidently, it would have been altogether anomalous to expect the introduction of the federal principle in the sphere of Centre-Province financial relations while the prevailing unitary relations remained unaffected in other spheres. Accordingly, it is by no means surprising to note that despite the wide support given to Strachey's plan by provincial governments as well as by a majority of the members of the Governor General's Council, the scheme was smothered by the personal and uncompromising opposition of the Governor General, Sir John Lawrence.

It is clear, however, that the ground was being prepared for the first bit of relaxation in the rigid central control of provincial finances. The first step in this direction was taken in 1871 by Lord Mayo who acted in the belief that[7]

> if we place the administration of portions, both of our revenue and expenditure, in the hands of the local governments it will lead to economy, to increased responsibility, to avoidance of much administrative difficulty and, above all, it will enable the rulers of the country gradually to institute, in various parts of the Empire, something in the shape of local self-government and will eventually tend to associate more and more natives of this country in the conduct of public affairs.

Under Lord Mayo's financial reforms, provincial governments were made responsible for the administration of certain services such as jails, police, medical services (except medical establishments), registration, education, roads and (civil) buildings. A fixed lump-sum grant was assigned to each province, in addition to the receipts from the departments concerned, in order to enable its government to carry out its responsibilities. Provincial governments were, at the same time, given the freedom to make their own appropriations in

[6] *Financial Statement*, 1861–62, speech of Mr. Samuel Laing, Finance Member, 16 April, 1862, p. 89.

[7] P. Banerji, *Provincial Finance in India*, Calcutta, 1929, p. 62.

respect of these services. Besides, the provincial governments were allowed the discretion to allocate these revenues among the different services under their charge as seemed best to them. Certain branches of revenue were treated as wholly central, *e.g.*, receipts from the post office and railways and tributes from the states. Other sources retained by the Centre to meet its enormous burden of expenditure were customs, salt and opium. The income from other sources, such as land revenue, excise, stamps, registration and forests was divided in certain proportions between the Centre and the provinces.

True, the arrangement was of an informal character and the Government of India retained their statutory powers of control and supervision. At the same time, this small and limited measure of decentralisation was significant as a first step towards reshaping the basis of Centre-Province relations in India. It resulted in an annual saving of some fifty lakhs of rupees to the Government of India. What is more important it injected in the provincial governments a sense of responsibility. It also encouraged them to effect economies in administration and gave them some interest in the development of local taxation. Writing four years after the introduction of the new system, Mr. Chapman, Financial Secretary to the Government of India, commented on its working as follows :[8]

> The reform...has been thoroughly successful... It is now generally acknowledged that its effects have been to promote a good understanding between the Supreme Government and the Local Governments, to increase the interest of the latter Governments in their work, to enlarge their power to do good.... These results have been obtained without sacrifice of the authority and dignity of the Government of India, and without any tendency to financial disintegration.

The arrangement was, no doubt, a great improvement on the existing and completely centralised system which had prevailed for half a century. However, the new system was not without its own defects. Perhaps, the most serious of these defects was the stereotyping of the inequalities in provincial finance since the settlement made in 1871 was based on the actual expenditure in the provinces

[8] Quoted in Bisheshwar Prasad, *The Origins of Provincial Autonomy*, Allahabad, 1946, p. 142.

for the year 1870–71 which in the case of Bombay, for example, was twice that of Madras and thrice that of Bengal. In his evidence before the Welby Commission, Gopal Krishna Gokhale[9] observed :

> That fact is that these inequalities are a legacy from the pre-decentralisation period, when the expenditure of different provinces was determined...not by the resources or requirements of those provinces but by the attention that their Governments succeeded in securing from the Central Government, *i.e.*, by the clamour they made. And when the first step was taken, in 1871, in the matter of decentralisation, the level of expenditure that had been reached in the different provinces was taken as the basis on which the contracts were made, and the inequalities that then existed were, so to say, stereotyped.

An attempt was made to remove some of the defects of Lord Mayo's system and to widen the area of relatively autonomous provincial action when, in 1877, Lord Lytton's government delegated financial control of the remaining provincial services (*i.e.*, services not under the direct control of administration) such as land revenue, stamps, law and justice and general administration to the provinces. At the same time, the revenues received from law and justice, *excise and license* (income) tax were made over to the provinces. The novel element in the new system lay in the transfer of certain heads of revenue to the provinces. It was laid down that any rise or fall in the yield from these heads as compared with the level at which it stood at the time of the assignment would be shared between the Centre and the provinces. The Lytton scheme transferred a little over 20 per cent of the revenues of India to the provinces and introduced an unprecedented element of elasticity in provincial finance. It aroused a deeper sense of responsibility in the provincial governments and further stimulated interest in the development of provincial resources.

The next step in financial devolution was taken, in 1882, by Lord Cromer during the viceroyalty of Lord Ripon. These reforms carried further the principle underlying the Lytton scheme by abolishing fixed annual grants and introducing a new system of alloca-

[9] *Ibid.*, p. 143.

tion. Certain heads of revenue which required uniformity of policy, such as customs, salts, currency, posts and telegraphs, railways etc., were reserved to the Centre. Certain other heads of revenue such as receipts from civil departments and public works were made entirely provincial. The remaining, such as stamps, excise, income-tax, registration, irrigation, and, later, land revenue, were 'divided' between the Centre and the provinces in certain specified proportions which varied from province to province in accordance with settlements made every five years. The main trouble with this system of quinquennial settlements was that, at the end of each five-year period, the balances standing to the credit of a province were resumed by the Government of India. Inevitably, the arrangement tended to put a discount on economy on the part of provincial governments since any reduction in local expenditure was used as a basis for a proportionately unfavourable settlement at the next revision in respect of the province concerned. As a result, there was an unhealthy tendency on the part of provincial governments to incur ill-considered or needless expenditure for no better reason than to prevent their savings from lapsing to the Centre. Sir A. Mackenzie, Lieutenant Governor of Bengal, a strong critic of the system, stated in the course of an address[10] to the Imperial Legislative Council:

> I deprecate the way in which the quinquennial revisions have so frequently been carried out. The provincial sheep is summarily thrown on its back, close-clipped and shorn of its wool and turned out to shiver till the fleece grows again.... The normal history is this: two years of screwing and saving and postponement of work, two years of renewed energy on the normal scale, and one year of dissipation of balances in the fear that, if not spent, they will be annexed by the Supreme Government at the time of revision.

This defect was partly removed in 1904 when Lord Curzon's government made the settlements quasi-permanent giving the provincial governments a more independent position and a more substantial and more enduring interest in the management of their resources than was previously possible.[11] According to Chanda, this was the

[10] Cited in Gyan Chand, *The Essentials of Federal Finance*, Bombay, 1930, pp. 36–37.

[11] *Report of the Royal Commission on Decentralisation*, 1909, para 60.

first step in the grant of financial autonomy to the provinces.[12] Responding to constant pressure from official as well as non-official quarters, Lord Hardinge's Government made the settlements permanent in 1912.

The measures of financial decentralisation summarised above were, it may be stressed again, of an informal and business character and did not affect either the Government of India's responsibility for the solvency of the provinces or its statutory control over them. The legal position was correctly stated by the Government of India in 1878 when it declared that despite the new procedure it had 'not contemplated the abrogation of the constitutional responsibility imposed upon it of exercising a general executive supervision over the proceedings of the Local Governments in the collection of the revenues and the administration of the services entrusted to their quasi-independent care'.[13] Provincial budgets continued to require the Supreme Government's approval. In the administration of their financial affairs, the provincial governments had to conform strictly to the rules, regulations and procedures formulated by the Government of India. The resources assigned to the provinces were limited and inadequate and their power to supplement them through local taxation was severely circumscribed. In fact, the provinces had no independent powers of taxation. Every proposal for a provincial levy required the sanction of the Government of India. Provincial governments had no power to raise loans in the open market, a restriction which was treated 'almost as an axiom of the Indian financial system'.[14] Finally, the 'divided' heads provided considerable scope for Central interference in the details of provincial finance.

While all this is true, it must nevertheless be noted that every step in financial decentralisation, however small, improved the status of the provinces and enlarged the powers and responsibilities of provincial governments. Compared with the position as it obtained before 1871, the provinces had a wider scope for developing the services entrusted to them and enjoyed greater freedom of action.

[12] Asok Chanda, *op. cit.*, p. 136.

[13] Financial Resolution No. 1514 dated 8 July 1873.

[14] *Report on Indian Constitutional Reforms*, 1918, p. 94.

According to B. R. Misra :[15]

> The history of financial devolution points to one unmistakable conclusion, namely, that in such a continent like India, administration whether political or financial, needs (sic.) to be decentralised in the interests of efficiency. With the small beginning of budgets by 'assignment' for a few departmental heads, we passed through a system of budgets by 'assigned' revenues, 'quasi-permanent settlement' and, ultimately, 'permanent settlements'. At each stage, a further step in financial decentralisation arose out of the needs to secure efficiency, economy and responsibility.... The extent of transformation can be realised by the fact that while before 1870, the Governor of Bengal could make 'no alteration in the allowances of public servants ... establish a new school or augment the pay of a daroga (a police officer) to the extent of a rupee', in 1919 the same authority could spend crores of rupees without any previous reference to the Government of India.

The reforms, no doubt, fell short of assuming a federal character as the essential principle of a centralised administration remained unaffected. It is necessary, however, to note the federal possibilities in a system which involved the demarcation of heads of revenue into 'imperial', 'provincial' and 'divided'. 'The system of division of financial administration which is followed in a federation unobstrusively crept into the system of financial settlement'.[16] It is significant that political leaders like Gokhale and Surendranath Banerjee had already begun to press for the abolition of 'Divided Heads' and for a complete and clear-cut separation of imperial and provincial revenues. While presenting his scheme to the Royal Commission on Indian Expenditure, Gokhale submitted that his proposal aimed at bringing the Indian financial system 'in line with the federal systems of finance in other countries *e.g.*, Germany, Canada, and the United States of America'.[17] Surendranath Banerjee was even more explicit in stating his view that the purpose of decentralisation schemes was

[15] B. R. Misra, *op. cit.*, n. 49, pp. 49–50.

[16] R. Coondoo, *The Division of Powers in the Indian Constitution*, Calcutta, 1964, p. 39.

[17] G. K. Gokhale, evidence before the Royal Commission on Indian Expenditure, 1895-1900, Q. 18036–18136.

'to establish a Federation of India'.[18] True, there is no indication that, at the time, official thinking envisaged India's development into a federation. Even the term 'provincial autonomy' had not yet acquired currency. But, as Bisheshwar Prasad has observed:[19]

> The suggestions regarding the separation of provincial finance, its relief from control by the Government of India and the legislative freedom of the provincial Legislative Councils coupled with the demand for partial responsibility of the executive to representative bodies manifest a hazy vision of it. The general notion was that as Provincial Governments carried on largely the administration of the country uncontrolled, they should be given financial and legislative freedom subject to the supervision of their Legislative Councils.

2. FINANCIAL RELATIONS UNDER MONTFORD REFORMS

The financial autonomy granted to the provinces under the successive schemes of financial devolution was appreciably enlarged by the Montford Reforms. Indeed, it was in the sphere of financial relations between the Central Government and the provinces that 'perhaps the greatest line of development took place'[20] and the Reforms set the stage for the federalisation of the system of government in India.

As we have seen above, a certain amount of spadework had been done in the period between 1871 and 1919 and that the provinces had acquired a certain measure of financial independence. But this independence was not very substantial. In any case, it had no statutory basis. The system of 'divided heads' continued to provide the Central Government with the opportunities as well as means of interfering with even minor details of adminstration and the 'doles' continued to provoke protests from provincial authorities and public men. It was the financial rod, as Bisheshwar Prasad has observed, with which the Central Government used 'to beat the provincial Governments into subordination'.[21]

[18] *Ibid.*, Q. 19233–34.
[19] Bisheshwar Prasad, *op. cit.*, n. 1, p. 245.
[20] B. R. Misra, *op. cit.*, p. 73.
[21] Bisheshwar Prasad, *op. cit.*, p. 355.

The authors of the Montford Reforms realised that if provincial autonomy 'was to be placed on a secure basis' and 'was to mean anything real, clearly the provinces must not be dependent on the Indian Government for the means of the provincial development'.[22] Accordingly, they addressed themselves to the task of providing provincial autonomy with a strong financial back-bone and the arrangements that eventually emerged altered the entire aspect of Centre-Province relations and placed India on the high-road to federalism.

In the first place, the Montford Reforms introduced a virtually complete separation of central and provincial sources of revenue. This was done by abolishing the 'divided heads', most of which (including land revenue, excise, irrigation, stamps etc.) were handed over to the provinces under the bifurcation of revenues based on the recommendations of the Meston Committee. 'The provinces gained what the Centre lost'.[23] Indeed, so completely did the new arrangement change the financial balance of power between the Centre and the provinces that, in the first few years of the working of the Montford Reforms, the Central Government was expected to face heavy deficits. To meet this situation, a system of progressively declining provincial contributions to the Centre was evolved by the Meston Committee.[24]

An enlargement of the taxing powers of the provinces was a necessary complement of the separation of provincial from central sources of revenue. Under the Scheduled Taxes Rules, the provinces acquired the statutory power to levy taxes listed in Schedule I without having to obtain the previous sanction of the Governor General.[25] The provincial governments also did not need the

[22] *Report on Indian Constitutional Reforms*, 1918, para 201.

[23] B. G. Sapre, *op. cit.*, n. 10, p. 278.

[24] These contributions which were discontinued in 1928, were a first charge on provincial revenues and were not subject to the vote of the provincial legislatures. In case of an emergency, the Governor General had the power to ask for contributions in excess of those fixed under the rules. These provincial contributions to the Centre have been aptly described as 'inverted grants'.

[25] Rules made under section 10 (3)(a) of the Government of India Act, 1919; Notification No. 311 dated 16 December, 1920; *Cmd* 891, 1920. These taxes were: (1) a tax on land put to uses other than agriculture; (2) a tax on succession; (3) a tax on any form of betting or gambling permitted by law; (4) a tax on advertisements; (5) a tax on amusements; (6) a stamp duty on

Governor General's previous sanction for permitting local or municipal boards to levy taxes given in Schedule II. The rules also provided that the Governor General-in-Council might, by order, make any additions to the taxes enumerated in the two schedules.[26]

The financial independence of the provinces was carried a step further by the new borrowing powers conferred upon them.[27] Before the reforms, provincial governments had no power to raise public loans on their own, the Government of India doing all the borrowing on their behalf. Rules made under the Government of India Act, 1919, empowered the provincial governments to enter the money market directly and float loans on the security of the revenues allocated to them. The power was, of course, subject to certain restrictions. Loans could be raised with the approval of the Governor General-in-Council for certain specific purposes, such as to meet the capital expenditure on the construction or acquisition of public works which could not reasonably be met out of the current revenues, if the Governor General-in-Council was satisfied that the projected construction or acquisition was likely to yield a prescribed return of interest.[28] Provincial governments were also authorised to raise loans for irrigation work and famine relief. In every case, the Governor General or the Secretary of State (depending on whether the loan was to be raised in India or abroad) had the power to decide upon the amount of the loan to be issued, the rate of interest and any or all of the conditions under which the loan was to be raised.[29]

Despite these statutory restrictions which hedged around the taxing and borrowing powers of the provinces, provincial governments acquired almost complete freedom to frame their own budgets and were given a considerable latitude in the expenditure of their funds,[30] even though a certain amount of central control flowed

any specified luxury ; (7) registration fee ; (8) a stamp duty other than duties of which the amount was fixed by Indian legislation.

[26] The Scheduled Taxes Rules, *op. cit.*, Rule 4.

[27] Local Governments (Borrowing) Rules : Rules under section 30 (IA) of the Government of India Act, 1919 ; No. 309-S, dated 16 December, 1920.

[28] *Ibid.*, Rule 2.

[29] *Ibid.*, Rule 3.

[30] Under Rule 16 of the Devolution Rules it was laid down that 'all

through the channel of the Finance and Audit Departments. It would be an exaggeration to say that the Montford Reforms placed the Centre-Province financial relations on a clearly federal basis. In fact, a considerable measure of central control over the provinces continued in this sphere in view of the Government of India's responsibility for the solvency of the provinces. Nevertheless, it can be stated that the separation of resources altered the character of the relationship between the Central and Provincial Governments,[31] and the new, though limited, powers of taxing and borrowing and of using their balances 'set the local Governments on the path to financial autonomy.' The degree of progress made under the Montford Reforms in the direction of financial autonomy for the provinces has been summed up in the following words[32] :

> The Act of 1919, and the devolution rules made thereunder, gave the provinces considerable latitude in financial matters. They now had the freedom to adjust the levies on transferred heads of revenue ; they similarly had the right to spend whatever they liked on the transferred subjects. Expenditure on reserved subjects alone continued to be subject to regulation and control by the Central government. The provinces were also given the power to float loans both in India and abroad on the security of their revenues but there were restrictions on the exercise of these powers.

3. FEDERAL FINANCE UNDER THE GOVERNMENT OF INDIA ACT, 1935

The Government of India Act, 1935, brought about a major

moneys derived from sources of provincial revenue shall be paid into the public account of which the Governor General-in-Council is the custodian and credited to the Government of the province.' 'The Governor General-in-Council was empowered, with the previous sanction of the Secretary of State in Council, to issue general or special orders regulating the procedure to be followed in the payment of moneys into, and in the withdrawal, transfer and disbursement of moneys from the public account, and the custody of moneys standing to account.' By a subsequent notification (Notification No. 1-A dated 3 January, 1922), it was provided that orders issued by the Governor General-in-Council might 'to such extent and for such purposes as may be stipulated, delegate power to prescribe procedure for the said purposes to the Auditor General, the Controller of the Currency and to the Local Governments.' (*Gazette of India*, 1922, part I, p. 4).

[31] Bisheshwar Prasad, *op. cit.*, n. 12, p. 360.

[32] Asok Chanda, *op. cit.*, pp. 138–39.

improvement in the fiscal position of the provinces by introducing the principle of federal finance [33] The Montford Reforms had, for the first time, assigned separate and independent sources of revenue to the Centre and the provinces. But the apportionment was of such a character that, after an initial set-back to the Centre which necessitated provincial contributions to the Central fisc, it worked steadily to the disadvantage of the provinces. The sources of revenue assigned to them were inadequate and relatively inelastic while, at the same time, they were burdened with the responsibility for the development of social services and nation-building activities. The result was deficit in the budgets of most of the provinces and, every year, provincial Finance Members bewailed the paucity of funds which handicapped their capacity to undertake essential programmes of economic and social development.

The Act of 1935 provided for important adjustments in the financial relations between the Centre and the provinces and, based as they were on the general principle of financial independence for the provinces tempered by considerations of the financial solvency and stability of the Centre,[34] these adjustments resulted in improving the financial position of the provinces and adding a measure of elasticity to their revenues. Besides a clear demarcation of federal and provincial sources of revenue, the Government of India Act, 1935, introduced a system of shared taxes of which the tax on income (other than agricultural incomes and incomes of corporations) was the most important example.[35] Apart from this prop to the financial equilibrium of the provinces, the Act also provided for further devolution of funds to the provinces by laying down that the proceeds of certain duties to be levied and collected by the Federa-

[33] C. N. Vakil and H. M. Patel, *Finances Under Provincial Autonomy*, Bombay, 1940, p. 3.

[34] The principle was accepted by the Peel Committee as well as the Joint Parliamentary Committee.

[35] Government of India Act, 1935, Section 138. The first Peel Committee (1931) had recommended that Income Tax (not including Corporation Tax) should be made a provincial tax. Ultimately, it was retained as a Federal tax but in accordance with the terms of the Niemeyer Award made under Section 138 of the 1935 Act, 50 per cent of the proceeds was distributed among the provinces.

tion[36] (*viz.*, duties on salt, duties of excise and export duties[37]) could, under the authority of an Act of the Federal Legislature, be shared with the provinces. In addition to this devolutionary support for provincial finance, the Act provided for the payment of Central grants-in-aid of the revenues of such provinces as might be in need of assistance to balance their budgets. Thus, 'there was built-in flexibility in the provisions adopted'.[38] Finally, the Act increased the borrowing powers of the provinces which could now raise loans in the open market on the security of their respective revenues subject to the condition that sanction of the Federal Government was necessary in case a Province wished to float a loan outside India or owed any debt to the Federation or any debt guaranteed by the latter.[39]

The changes made by the 1935 constitution in the financial relations between the Centre and the provinces were, as we have said above, based on the general principle of financial independence for the provinces. However, they cannot be said to have given complete financial independence to the latter. According to one critic of the system, the sources of revenue were so distributed that provincial prosperity and development were consciously subordinated to Central security,[40] and 'all elastic sources of revenue had been collared by the Government of India'.[41] There is, no doubt, some basis for this criticism. (One may note parenthetically, however, that similar criticism is frequently directed against the financial provisions of our new constitution which are, to a considerable extent, patterned on those laid down in the 1935 Act.) It remains true, nevertheless, that the Act did make a significant improvement in the financial status of the provinces and, by giving them a measure of inde-

[36] *Government of India Act*, 1935, Section 140 (1).

[37] Subject to the provisions of Section 140 (2).

[38] Asok Chanda, *op. cit.*, p. 150.

[39] *Government of India Act*, 1935, Section 163.

[40] Masani in C. Y. Chintamani and M. R. Masani, *India's Constitution At Work*, Madras, 1940, p. 39. P. J. Thomas, on the other hand, declared that under the Act of 1935 'the financial authority of the Provinces is now nearly as complete as can be under a federal constitution'. ('Provincial Finances Under Autonomy', *The Indian Journal of Political Science*, Vol. I, No. 1, July-September 1939, p. 69.)

[41] C. Y. Chintamani and M. R. Masani, *op. cit*, p. 40.

pendence in raising their revenues ordering their expenditures, injected some firmness into the financial back-bone of provincial autonomy.

4. PROVISIONAL ADJUSTMENTS, 1947–1952.

With the achievement of independence and the separation of certain parts of India to form Pakistan, a readjustment of financial arrangements between the Government of India and the provinces especially as regards the distribution of income tax and jute export duty became necessary pending the framing of free India's constitution and setting up of the Finance Commission. As regards income tax, the basic scheme of Sir Otto Niemeyer was retained. The shares of the truncated provinces of Punjab and Bengal were reduced in proportion to population and the released percentages of Sind and North-Western Frontier Province were pooled for redistribution. Provincial shares were refixed. As for the jute export duty, the provincial share was reduced from 62½ per cent to 20 per cent (in view of the jute growing areas which had gone to Pakistan) but the basis of the distribution of the share among the provinces remained unchanged.

When the new Constitution was being framed, the Constituent Assembly set up an Expert Committee, with N. R. Sarkar as Chairman, to report on some aspects of the financial provisions. The Committee made some important recommendations, suggesting basic principles for the division of taxes between the Union and the States. The Sarkar Committee was of the view that the entire net proceeds of income tax (including corporation tax and income tax on federal emoluments) should be made sharable between the Union and the *units* except to the extent that the tax was attributable to centrally administered areas. It proposed 60 per cent as the provincial share, 20 per cent on the basis of population, 35 per cent on the basis of collection and the remaining 5 per cent for adjustments to mitigate any hardships that might arise from the application of the other two criteria. As regards jute export duty, the Committee recommended the abolition of existing arrangements for the sharing of the net proceeds with the provinces and, with a view to preventing hardship to the four jute-growing provinces, it suggested payment of fixed grants to them. The Committee recommended, further, that 50 per cent of the net proceeds of the (Central) excise duty on

tobacco should be distributed among the provinces on the basis of estimated consumption. Finally, it was this Committee which suggested the appointment of a Finance Commission, somewhat on the lines of the Australian Commonwealth Grants Commission, to deal *inter alia* with matters relating to the division of revenues between the Union and the States and the distribution among the States of the States' share.

In view of the fact that the Finance Commission could not be set up forthwith, the States' share of income tax and its distribution among the States as also the payment of grants-in-aid to the States under Articles 273 and 275 of the Constitution had to be regulated by order of the President of India for the period between the commencement of the Constitution and the appointment of the Finance Commission. However, as some States had criticised the arrangements regarding the allocation of shares of income tax and grants-in-aid in lieu of jute export duty made by the Central Government after partition, the matter was referred to C. D. Deshmukh and it was agreed that his recommendations would be in the nature of an award. In regard to income tax Deshmukh made the distribution mainly on the basis of population providing for minor adjustments with a view to rounding off and giving a slight weightage to the weaker States. The following table shows the percentage distribution of income tax among the States of the States' share.

Province	Pre-partition share %	Share under Government of India allocation %	Share under Deshmukh Award %
Madras	15	18	17.5
Bombay	20	21	21.0
West Bengal	20*	12	13.5
Uttar Pradesh	15	19	18.0
Punjab	8*	5	5.5
Bihar	10	13	12.5
Madhya Pradesh	5	6	6.0
Assam	2*	3	3.0
Orissa	2	3	3.0

* Relate to the undivided Provinces.

Source : Report of the (First) Finance Commission, 1952.

As regards grants-in-aid in lieu of a share in the jute export duty Deshmukh felt that the provision in the Constitution 'alters completely the constitutional rationale of the old arrangement' and recommended annual payments of the following amounts to the four States concerned pending the recommendations of the Finance Commission :

State	Rupees in lakhs
West Bengal	105
Assam	40
Bihar	35
Orissa	5

The Award remained in force from 1st April, 1950 to 31st March, 1952.

CHAPTER III

FINANCIAL RELATIONS UNDER THE CONSTITUTION

1. THE CONSTITUTION AND THE ACT OF 1935

As we have stated in Chapter I above, the allocation of financial resources between the Centre and the units is the most vital and, at the same time, the most difficult of federal problems. Hardly any federation of the world has solved this problem with complete success. In dealing with the problem, the makers of the Indian Constitution took the easy line of generally following the pattern laid down in the Government of India Act, 1935, as regards financial relations between the Centre and the provinces. Following this pattern, the Constitution has sought to separate the financial resources of the Centre and the States as far as possible and has avoided the element of concurrence found in the sphere of finance in older federations. This separation, however, is not complete. The Constitution takes cognizance of the fact that it is neither possible nor desirable to divide the financial powers of the Centre and the units into water-tight compartments.

As in the case of the 1935 Act, the Constitution of India provides for separation of tax resources as well as sharing of tax revenue. The list of taxes assigned wholly to the States is, with a few additions, the same as the one incorporated in the 1935 Act. Further, as in the Government of India Act, 1935, the Constitution provides for the sharing of the net proceeds of non-agricultural income tax and (subject to Union legislation) of Union excise duties. The Constitution also follows the 1935 pattern in providing for general and specific central grants-in-aid to the States (Articles 273 and 275).

In two significant aspects, however, the Constitution makes a departure from the Act of 1935. For one thing, whereas the latter left the allocation of residuary powers to the Governor General's decision, the Constitution places these powers (including those per-

taining to financial resources) in the Centre. The second departure is seen in the provision for the establishment of the Finance Commission. Under the 1935 Act, the sharing of taxes between the Centre and the provinces and the disbursement of central grants-in-aid were left to be regulated by executive orders of the Governor General. The Constitution, on the contrary, requires that the sharing of the net proceeds of income tax between the Centre and the States and that the apportionment of the States' share among the States *inter se* must be governed by Presidential orders made after considering the recommendations of the Finance Commission. As for the sharing of the net proceeds of Union excise duties, the Constitution provides for the need of parliamentary legislation and, at the same time, assigns an advisory role to the Finance Commission.

While the Constituent Assembly was engaged in the task of hammering free India's Constitution into shape, a new dimension was added to the settlement of the financial equation between the Centre and the component units with the integration of the former princely states. Under British rule, these states had exercised a great deal of financial autonomy and it was largely owing to their unwillingness to surrender their fiscal independence that they had refused to join the All-India Federation contemplated under the Government of India Act, 1935.

Originally, the Expert Committee (under the Chairmanship of N. R. Sarkar) of the Constituent Assembly had recommended that the states acceding to the Indian Union should give up, without compensation, their right of levying internal customs but that the administration of maritime customs should be taken over by Central Government with compensation to the affected states. The Committee further recommended that the Indian income-tax and central excise duties should be made applicable in the states and that the latter should be suitably compensated for the loss of privileges and immunities hitherto enjoyed by them.

The recommendations of the Sarkar Committee were soon overtaken by a rapidly developing political situation. Under the strong and sagacious stewardship of Sarder Patel, the Ministry of States was able, almost within a year of the achievement of independence, to persuade or pressurise all the princely states lying within the territorial boundaries of the Union of India into accession on

the basis of an acceptance of List I and List II (except for financial provisions) of the Seventh Schedule. As a result of this, the question of financial relations between the Union and the states had to be re-examined. For this purpose, the Ministry of States set up a new Committee (The Indian States' Finance Enquiry Committee) headed by V. T. Krishnamachari. Postulating constitutional parity between states and provinces in all respects, the Committee came to the conclusion that :[1]

> From the concept of States and Provinces as equal partners, it inevitably follows that the Central Government should function in States over the same range of subjects and with the same powers as in Provinces. It is only in this way that the Union of India will gain in strength and its policies in effectiveness. There is no federation in which the Central Government possesses different levels of powers and authority in the units comprised in it.

As a natural corollary to this conclusion, the Committee stressed the principle of equality of contributions to the Central fisc and recommended[2] that former princely states should contribute to the finances of the Union and receive grants-in-aid and other forms of financial assistance on the same basis as the provinces. As a result, when the framing of the constitution was completed, the former princely states (which had been integrated into the Union of India as states of the 'B' or 'C' parts) a uniform pattern of financial relations had been evolved as between the Union on the one hand and all its component units on the other. 4392

[1] *Report of the Indian States' Finance Enquiry Committee*, 1948-49, para 11.

[2] During the consideration of the Draft Constitution, K. Santhanam observed : 'The artificial distinction between the Provinces and States should vanish as quickly as possible. The only impediment is that certain financial interests have developed...and if we can find a formula to protect the States from the financial consequences of adopting the same constitution as the provinces, the States may not object to fall in line with the Provinces. Therefore, I suggest that we should adopt the principle that no State should suffer by falling in line with the Provinces and let us give them a guarantee that they will be recouped from Central funds for any loss caused by falling in line with the Provinces'. *Constituent Assembly Debates*, vii, 3, pp. 264-65.

2. THE CONSTITUTIONAL PATTERN

When constitutional provisions relating to Union-State financial relations were debated in the Constituent Assembly, there was no dearth of doughty champions of State autonomy in the financial sphere. These spokemen of States' rights missed no opportunity of raising their voice against provisions which, in their opinion, would have the effect of placing the States in a position of financial subordination to the Centre or leave them with inadequate resources. Thus, K. Santhanam asserted that 'the provinces will be beggars at the doors of the Centre'.[3] Others like Biswanath Das pleaded particularly on behalf of 'poorer' provinces.[4] Speaking on the Experts Committee report, the same member laid stress on the need for providing adequate resources to the States. He declared :[5]

> The needs of the provinces are almost unlimited, particularly in relation to welfare services and general development. If these services, on which the improvement of human well-being and increase of the country's productive capacity so much depend, are to be properly planned and executed, it is necessary to place at the disposal of provincial Governments adequate resources of their own, without their having to depend on the variable munificence or affluence of the Centre.

Sir A. Ramaswami Mudaliar argued elaborately to prove that the financial balance of power blue-printed in the Draft Constitution was unfavourable to the States. He complained that while the units (he used the term 'provinces' consistently) were to carry the burden of nation-building activities, their financial resources would not be commensurate with their responsibilities.[6]

The point we seek to make here is that the allocation of financial resources between the Centre and States received a great deal of attention at the hands of the constitution-makers. While the desire to have a 'strong' Centre was more or less universal, the viewpoint of State autonomy was by no means inadequately represented. The pattern of financial relations which finally emerged may now be summarised.

[3] *Constituent Assembly Debates*, v. 3, p. 55.

[4] See, for example, *C.A.D.*, ix, 8, p. 275.

[5] *Ibid.*, ix, 6, p. 205.

[6] *Ibid.*, v, 4 pp. 80–85.

Following the precedent set in the Government of India Act, 1935, the Constitution seeks to make a more or less clear division of financial resources between the Centre and the States. There are as many as nineteen items of revenue in List II of the Seventh Schedule. These sources of revenue belong exclusively to the States. The States are free to determine the rates of these taxes and duties, to collect them and to appropriate their proceeds for their own use. They are :

1. Land revenue (item 45).
2. Taxes on agricultural income (item 46).
3. Duties in respect of succession to agricultural land (item 47).
4. Estate duty in respect of agricultural land (item 48).
5. Taxes on lands and buildings (item 49).
6. Taxes on mineral rights, subject to any limitation imposed by Parliament by law relating to mineral development (item 50).
7. Duties of excise on the following goods manufactured or produced in the States and countervailing duties at the same or lower rates on similar goods manufactured elsewhere in India :
   (*a*) alcoholic liquors for human consumption,
   (*b*) opium, Indian hemp and other narcotic drugs and narcotics but not including medicinal and toilet preparations containing alcohol or any substance in paragraph (*b*) of this entry (item 51).
8. Taxes on the entry of goods into a local area for consumption, use and sale therein (item 52).
9. Taxes on the consumption or sale of electricity (item 53).
10. Taxes on the sale or purchase of goods other than newspapers[7] (item 54).

[7] This item was amended by the Constitution (Sixth Amendment) Act, 1956. As a result of this amendment a new item (Entry 92A) was added to the Union List, *viz.*, 'Taxes on the sale or purchase of goods other than newspapers where such sale or purchase takes place in the course of inter-state trade or commerce.' A consequential change was made in the State List so that the amended item 54 of this list reads : 'Taxes on the sale or purchase of goods other than newspapers subject to the provision of Entry 92A of List I'. Though

11. Taxes on goods and passengers carried by road or inland waterways (item 56).
12. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads including tramcars subject to the provisions of Entry 35 of List III (item 57).
13. Taxes on animals and boats (item 58).
14. Tolls (item 59).
15. Taxes on professions, trades, callings and employments (item 60).
16. Capitation Taxes (item 61).
17. Taxes on luxuries including taxes on entertainments, amusements, betting and gambling (item 62).
18. Rates of stamp duty in respect of documents other than those specified in the provisions of List I (entry 91) with regard to rates of stamp duty (item 63).
19. Fees in respect of any of the matters in List II but not including fees taken in any court (item 66).

The Union List enumerates twelve sources of tax revenue though only a few of these can be said to belong exclusively to the Union Government.[8] These twelve items are :

1. Taxes on incomes other than agricultural income (item 82).
2. Duties of customs including export duties (item 83).
3. Duties of excise on tobacco and other goods manufactured or produced in India except:
    (*a*) alcoholic liquors for human consumption ;
    (*b*) opium, Indian hemp and other narcotic drugs and narcotics but including medicinal and toilet prepara-

apparently involving a restriction on the taxing powers of States, the amendment was made with a view to preventing State taxation from erecting barriers to the free flow of inter-State trade and commerce.

[8] Apart from tax resources assigned to the Centre, the Union Government derives revenues from railways (item 22), airways (item 29), posts and telegraphs, telephones, wireless, broadcasting and other means of communication (item 31), property of the Union and revenue therefrom (item 32), fees in respect of any of the matters in the Union List but not including fees taken in any Court (item 96), public debt of the Union (item 35), currency, coinage and legal tender ; foreign exchange (item 36), foreign loans (item 37), Reserve Bank of India (item 38), and lotteries organised by the Government of India or the Government of a State (item 40).

tions containing alcohol or any substance included in paragraph (6) of this entry (item 84).

4. Corporation tax (item 85).
5. Taxes on the capital value of assets, exclusive of agricultural land, or individuals and companies; taxes on the capital of companies (item 86).
6. Estate duty in respect of property other than agricultural land (item 87).
7. Duties in respect of succession to property other than agricultural land (item 88).
8. Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights (item 89).
9. Taxes other than stamp duties on transactions in stock exchanges and futures markets (item 90).
10. Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts (item 91).
11. Taxes on the sale or purchase of newspapers and on advertisements published therein (item 92).
12. Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce[9] (item 92A).

The Constitution also assigns residuary tax powers to the Centre according to Entry 97 of the Union List. 'Any other matter not enumerated in List II or List III including any tax not mentioned in either of these Lists.'

[9] This entry, which was added to the Union List by the Constitution (Sixth Amendment) Act, 1956, and must be read with Article 286 of the Constitution, has given rise to a great deal of litigation and has been interpreted by the Supreme Court in a number of cases. Reference may be made here to a couple of recent cases. In *The State Trading Corporation of India Ltd.*, V. *The State of Mysore* (1963) II, S.C.J., 131, the Court held that no State sales-tax could be levied on the sale of cement, under permit, to be supplied in Mysore from a factory situated outside the State. In *William Jacks & Co., Ltd.*, V. *The State of Bihar* (1964, I, S.C.J., 351), the Court ruled that no State sales tax was leviable on various kinds of machinery supplied by M/S William Jacks and Co., which had its place of business in Calcutta, to purchasers in Bihar.

As we have pointed out above, only a few of the tax items enumerated in the Union List are exclusively assigned to the Centre in the sense that they are wholly appropriated for the use of the Union Government. These are customs including export duties, corporation tax ; and taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies. As for the other taxes mentioned in the Union List, their proceeds are (or may be) shared or wholly appropriated by the States.

There is, for example, the income tax. The Centre has the power to levy this tax, to determine its rate and to collect it. However, the Constitution provides[10] that the Centre must share the net proceeds of this tax with the States and that the share of the States has to be determined by the President by order after considering the recommendations of the Finance Commission.

In a third category stand Union duties of excise (other than those allotted to States under Entry 51 of List II of the Seventh Schedule) which are levied and collected by the Government of India but may be shared with the States if Parliament so decides. The Constitution authorises Parliament to decide whether a share of these duties should be given to the States and to lay down the principles in accordance with which the share of the States should be distributed among them.[11]

The fourth category of taxes are those which the Centre can levy and collect but the entire proceeds whereof (except those attributable to Union territories) go to the States in accordance with such principles as may be laid down by Parliament by law.[12] These include succession and estate duties ; terminal taxes on passengers and goods carried by railway, sea or air ; taxes on railway fares and freights ; taxes other than stamp duties on transactions in stock exchange and futures markets ; taxes on the sale or purchase of newspapers[13] ; sale or purchase taxes on inter-State trade.

[10] *Constitution of India*, Article 270 (4) (*a*) (*ii*). Article 271 empowers the Union Government to lay a surcharge on income tax and appropriate it exclusively for the purposes of the Union.

[11] *Constitution of India*, Article 271. In practice, Parliament has been acting in this matter on the recommendations of the Finance Commission.

[12] *Constitution of India*, Article 269.

[13] K. Santhanam has described the history behind the inclusion of taxes

The fourth and last category of taxes enumerated in the Union List are those which are to be levied by the Centre but are to be collected by the States and appropriated by them for their own purposes.[14] These are stamp duties and excise duties on medicinal and toilet preparations containing alcohol. This means that the Centre levies the tax and determines the rate of the duty to be paid on the alcohol in medicinal and toilet preparations while the tax is collected by each State and appropriated by it for its own purposes (except that these taxes are collected and appropriated by the Government of India in so far as they are leviable in any Union Territory).

The Constitution confers the power of borrowing on both the Union and the States though the two are not placed on equal footing in this matter.

The Union Government has unrestricted powers of borrowing in India and abroad subject only to such limits as may from time to time be fixed by Parliament by law.[15] On the contrary, the borrowing powers of the States are both territorially and otherwise limited.[16] They have no power to raise loans outside India. Within India a State may receive loans from the Government of India or float public loans. However, a State cannot raise a public loan without the consent of the Government of India if there is still outstanding any part of a loan which has been advanced to it by the Government of India or in respect of which a guarantee has been given by the Government of India.

It was realised by the constitution-makers that the financial

on the sale or purchase of newspapers in this group. He writes: 'All sales and purchase taxes were State taxes and the tax on the sale or purchase of newspapers was also a State tax under the Government of India Act. At the time of transfer of power, some States began to levy sales-tax on newspapers; for example, newspapers which came from Bombay had no sales-tax in Bombay but sales-tax had to be paid in Madras. This happened in other States also. There was a great agitation among the newspapers that this should be centralised. We were at that time framing the Constitution and the Constituent Assembly transferred the sales-tax on newspapers to the Union List. It is still a State source of revenue but the actual levy and the collection has to be done by the Centre.' *Union-State Relations in India*, Bombay, 1960, p. 32.

[14] *Constitution of India*, Article 268.

[15] *Ibid.*, Article 292.

[16] *Ibid.*, Article 293.

balance of power established in the Constitution would leave the States with inadequate resources for meeting their manifold responsibilities in respect of social services and welfare activities. Provision has therefore been made for Central grants-in-aid to the States. Article 142 of the Government of India Act, 1935, had provided for grants-in-aid to the provinces by the Central Government. Under this provision, grants were made to certain provinces on the recommendations of Sir Otto Nieymier. In making his recommendations Sir Otto took into consideration the increased share of the duties on the export of jute products to Bengal, Orissa, Bihar and Assam and the benefits accruing to these provinces and the N.W.F.P. from the cancellation of their entire debt to the Government of India. All these grants, which were paid till the partition of India in 1947, were unconditional.

The new Constitution provides for grants-in-aid of the revenues of States on a much larger scale than the Government of India Act, 1935. Article 273 provides for grants-in-aid to Assam, Bihar, West Bengal and Orissa in lieu of the export duty on jute and jute products. Article 275 provides for grants-in-aid of the revenues of such States as Parliament may determine to be in need of assistance and different sums may be fixed for different states. The proviso to this Article provides for grants-in-aid to States to meet the cost of such schemes of development as may be approved by the Union Government for promoting the welfare of Scheduled Tribes or raising the level of administration of the Scheduled Tribes Areas. Grants under Article 275 (barring the two provisos to the Articles) are to be determined on the basis of the recommendations of the Finance Commission. Under Article 282, the Union Government and the States are authorised to make grants for any public purpose notwithstanding that the purpose is not one with respect to which Parliament or the Legislatures of States, as the case may be, may make laws. The Finance Commission has nothing to do with these grants.

A brief reference may be made here to the emergency provisions of the Constitution under which the financial autonomy of the States can be temporarily restricted and some of the sources of their revenue brought under Central control. Thus, during the operation of a Proclamation of General Emergency, the President of India 'may......

by order direct that all or any of the provisions of Articles 268 to 279 shall have effect subject to such exceptions or modifications as he thinks fit.'[17] Besides, the President's powers under Article 352 can be used to alter or modify the distribution of revenues made in the Seventh Schedule to the Constitution. Further, during the operation of a financial emergency, the executive authority of the Union extends to the giving of directions to any State to observe such canons of financial propriety as may be prescribed in the direction and to the giving of such other directions as the President may deem necessary and adequate for the purpose.[18] These directions may require reduction of salaries and allowances of any or all classes of State employees[19] and the submission to the President of all money bills passed by the State legislature for his consideration.[20] Discussing the varying restrictions these emergency provisions may place on the financial independence of the States, Hriday Nath Kunzru declared in the Constituent Assembly[21] :

> The President will enjoy full authority to alter the financial relations between the Union and the States in any manner he likes.... What are the Provinces (States) to do in these circumstances ? So far as I can see they are enjoying the blessings of financial *nirvana*.

3. THE FINANCIAL BALANCE OF POWER : AN ANALYSIS.

Except for the general principle adopted in all federations (and incorporated in the Indian Constitution as well) that federal levies should be uniform throughout the Union and should not discriminate between the States, the financial balance of power in our Constitution 'differs basically from that of other major federations.'

One of the distinctive features which distinguish federal financial relations in India from those in the older federations is the fact that the Indian Constitution avoids concurrent jurisdiction in the sphere of taxation. Such concurrent jurisdiction is provided for in

[17] *Constitution of India*, Article 354 (1).
[18] *Ibid.*, Article 360 (3).
[19] *Ibid.*, Article 360 (4)(i).
[20] *Ibid.*, Article 360 (4)(ii).
[21] *Constituent Assembly Debates*, IX, 13, pp. 508–509.

older federations[22] and has caused a lot of trouble and confusion. Serious attempts have had to be made in these federations to remove or reduce these conflicts and confusion. In Canada and Australia the simultaneous levy of income tax and corporation tax by the Centre and the Units created serious problems and arrangements have had to be made to persuade local governments through pressure and compensation to surrender their constitutional right to levy these taxes. In the United States, concurrent taxation of incomes (of individuals and corporations) continues to some extent even today and the practice has been buttressed by judgments of the Supreme Court. One result of this situation is that major industrial business concerns have to pay taxes in several or all the States besides having to pay the federal tax.

The Indian Constitution has rigorously avoided such concurrence in taxing power and has, therefore, precluded the possibility of multiple taxation. On the contrary, 'the taxing powers of the Union and the States have been completely separated and made mutually exclusive'.[23] Entries relating to tax resources are enumerated in the Union and State Lists but there is no such entry in the Concurrent List at all. In short, the Constitution gives independent sources of revenue to the Union and the States and, to that extent, conforms more truly to the federal principle than any of the older federations. This separation and relative independence of the financial sources of the Centre and the units is, as Santhanam has correctly observed, 'the product of our history'.[24] The Montague Chelmsford Reforms (1919) made a virtually complete separation of the tax sources of the Centre and the provinces. The process was completed under the Government of India Act, 1935. The new Constitution of India has followed this tradition.

There is, however, another aspect of this tradition and it qualifies, to some degree, the separation of the financial resources of the Centre and the States. The Montford Reforms and the Government of India Act, 1935, progressively enlarged the fiscal authority

[22] F. Shirras has calculated that in the U.S.A. there is overlapping for more than 90 per cent of the tax proceeds. Quoted in D. T. Lakdawala, *Union-State Financial Relations*, Bombay, 1967, p. 8.

[23] Asok Chanda, *op. cit.*, p. 179.

[24] K. Santhanam, *op. cit.*, p. 30.

and autonomy of the provinces. However, the financial provisions of these Acts left the provinces (except for a brief span under the Montford system when the equation worked in the opposite direction) in a position of deficit and dependence on the Centre. In view of this situation, the Government of India Act, 1935, provided for the sharing of the proceeds of certain taxes and duties between the Centre and the provinces and for Central grants-in-aid to the provinces in need of assistance. But discretionary powers of the Centre in these matters, particularly as regards grants-in-aid, acted as a serious limitation on the autonomy of provinces and was, to that extent, a departure from the basic principle of federalism. As we have seen above, the new Constitution also provides for both obligatory and permissive sharing of taxes and for grants-in-aid. However, it introduces what Chanda has described as 'safeguards and refinements' which have made the financial provisions more consistent with the federal concept.[25] The most important of these safeguards and refinements is the creation of an independent agency like the Finance Commission. Since the sharing of taxes and the payment of Union grants-in-aid (under Article 275)[26] are made on the recommendation of this agency, the consequent devolution of funds does not involve encroachment on State autonomy. The financial resources transferred to the States either in the form of their part of the proceeds of shared taxes or of grants-in-aid under Article 275 may, in fact, be treated as independent sources of State revenues, quite as independent as the funds acquired by them through taxes and non-tax sources enumerated in List II of the Seventh Schedule. The main object behind the apparently complex pattern of financial relations in which some taxes are exclusively under Union or State jurisdiction and others levied and collected by one while the proceeds thereof go to the other and yet others the proceeds whereof must or may be shared is to protect the financial autonomy of the States and, at the same time, to provide for uniformity where necessary. Separation is there but it does not place the Union and the States in absolutely water-tight compartments. Separation, in fact, is accom-

[25] Asok Chanda, *op. cit.*, p. 181.

[26] Central grants to the States under Article 282 are outside the purview of the Finance Commission. It is the extensive resort to these grants that has tended to upset the financial equilibrium established by the Constitution.

panied by some degree of integration.

Another feature of the pattern of Union-State financial relations as laid down in the Constitution is the relative inadequacy of the financial resources of the States. There were strong complaints on this point in the Constituent Assembly and these complaints have continued to be voiced since the Constitution went into operation. We have referred earlier to the elaborate analysis made by Sir A. Ramaswamy Mudaliar of the financial provisions of the draft Constitution. The conclusion he drew from his analysis was that the resources placed at the disposal of the States would be altogether inadequate in view of the nation-building activities with which they were burdened.[27] Santhanam expressed the view that the financial provisions of the Constitution[28] 'have put all taxation except land revenue and one or two other diminishing items like excise on intoxicating liquors in the federal list. The provinces (States) will be beggars at the door of the Centre'.

The complaint that the States have been left in a weaker position *vis-a-vis* the Centre so far as the division of financial powers is concerned has been frequently made in the years following the inauguration of the Constitution. Typical of this criticism are the following observations[29] :

> It is almost common knowledge that the Centre has got all the important and elastic sources and the States are starved to some extent, though almost all the nation-building departments are in the care of the States only... From the time of the British, the emphasis has been on the stability of the Centre and adequacy of the Centre's resources... The Centre has been given more sources than it can digest.

In regard to this criticism, a few comments may be made. In the first place, while it is perhaps true that the Centre's sources of revenue are relatively more elastic than those of the States and that the States would be financially hard up if they had to rely exclusively on the tax sources enumerated in List II of the Seventh Schedule, the Constitution includes provisions which impart a measure of

[27] See n. 6 supra.

[28] *Constituent Assembly Debates*, v. 3, pp. 54–55.

[29] K. V. Rao, *Parliamentary Democracy of India*, Calcutta, 1965, p. 324.

elasticity to State revenues. The States receive the proceeds of a number of taxes which are mentioned in Union List and which are to be levied by the Centre and collected either by the Centre or the States themselves. Besides, the States are entitled to a share of the proceeds of income-tax and may be given a share of the proceeds of Union excise duties. Referring to this aspect of federal financial relations in India, the Taxation Enquiry Commission observed in its report[30] :

> Before the war the Government of India with income tax, customs and excise had a comparatively elastic revenue system while the then Provinces with land revenue and liquor excises had a relatively inelastic revenue system. The States still lean heavily on land revenue and liquor excises but much less heavily than before. They now have the sales tax, and have also found that their other taxes contain a considerable measure of elasticity. While the Central Government still have the income tax, custom and excise duties, it no longer has the exclusive use of these *viz.*, income tax and excises. The sharing by the State Governments in the proceeds of Central taxes, and the institution of substantial grants by the Central Government for both general and specific purposes have between them imparted a measure of elasticity to the State revenues which was unknown to the provinces in the pre-war period. Even in the taxes which are both collected and retained by the States, there is a greater degree of elasticity than was in evidence before the war.

When it is recalled that the sharing by the States of the proceeds of income tax and Central excise duties and the payment of Central grants-in-aid to the States (under Article 275 of the Constitution) are done on the recommendations of the Finance Commission, it becomes clear that the elasticity imparted to State revenues through these means is not gained at the cost of State autonomy. In this respect, States of the Indian Union are in a more fortunate position than the component units of older federations like Australia and Canada. The dependence of the States in Australia and the provinces in Canada on their respective Central governments as a

[30] *Report of the Taxation Enquiry Commission, 1953–54*, Government of India, Ministry of Finance, 1955, Para 43, pp. 31–32.

result of the insufficiency of their own independent resources is much greater than the dependence of the States, in India on the Union Government. K. C. Wheare has described the situation in Australia in the following terms[31]:

> The control of the government of the Commonwealth of Australia over the governments of the States has become so great that some observers say that in practice the States of Australia are little more than the administrative agencies of the Commonwealth. *The control has come chiefly from the greater financial resources of the Commonwealth and has shown itself particularly in the increased reliance of the States upon grants from the Commonwealth for the performance of most of their important functions.*

In the United States also the States have become increasingly dependent on federal assistance. Nor is the situation in Canada basically different. In each of these countries, says A. H. Birch[32]:

> It has been the federal government that has been favoured by the division (of revenue resources); at first because of the federalisation of customs duties, later because it has also been able to exploit more effectively those fields, such as income tax, which are open to both authorities.

According to another authority, the constitutional position in all these federations is one of federal dominance.[33] From the point of view of the States, the situation as established by the Indian Constitution is considerably more satisfactory. It may be conceded that the Centre has been given a relatively larger amplitude of financial resources and that it was realised *ab initio* that the exclusive sources of revenue assigned to the States would not be adequate for the discharge of their manifold responsibilities. Our analysis of the financial balance of power laid down in the Constitution has shown that the States are to some extent dependent upon the Centre. It is,

[31] K. C. Wheare, *Federal Government*, London, 1956, p. 28.

[32] A. H. Birch, *Federalism, Finance and Social Legislation*, London, 1955, p. 6.

[33] Carl J. Friedrich and Theodore S. Baer, 'Public Finance' in Carl J. Friedrich and Robert R. Bowie (Eds.), *Studies in Federalism*, Boston, 1954, p. 367.

however, clear that the Constitution has provided for safeguards to ensure that Central assistance to the States should not lead to the erosion of State autonomy. As Alexandrowics has put it, the States have 'the minimum of financial autonomy......which is needed to make them constitutionally self-sufficient'.[34] The Supreme Court of India has also expressed the view that 'the Scheme of the Constitution with regard to financial relations between the Union and the States, devised by the Constitution-makers, is such as to ensure an equitable distribution of the revenues between the Centre and the States'.[35] Paul H. Appleby, in fact, has stressed that in India 'the States have revenue resources proportionately larger than States in any other federal system'.[36] What has happened during the past seventeen years is that national planning and the increasing resort to discretionary Central grants to the States under Article 282 have tended to distort the original pattern of financial relations embodied in the Constitution and have led to a degree of the States' dependence on the Centre not contemplated by the Constitution-makers. We will examine this point in greater detail in the next chapter.

4. THE DOCTRINE OF IMMUNITY OF INSTRUMENTALITIES AND THE INDIAN CONSTITUTION.

The relative weakness of the States in India *vis-a-vis* the Centre in the field of financial relations is emphasised by the fact that the Constitution gives only limited recognition to the doctrine of reciprocal immunity of instrumentalities. The doctrine was propounded by the Supreme Court of the United States in the well-known case of *McCulloch* V. *Maryland*[37] to mean that 'when two separate Governments are established in a Federal Constitution, each with a limited jurisdiction, the power of each Government shall be construed as being under an implied limitation that it shall be so exercised as not

[34] C. H. Alexandrowics, *Constitutional Developments in India*, Madras, 1957, p. 203.

[35] In its advisory opinion on a reference made by the President of India under Article 143(1) of the Constitution, 1964, II, S.C.J. 51, at p. 58.

[36] Paul H. Appleby, *Public Administration in India, Report of A Survey*, 1953, p. 22.

[37] Advisory Opinion delivered by the Supreme Court of India on a Reference made by the President of India under Article 143(1) of the Constitution ; n. 35, above.

to impair the functions allotted to the other Government'.[38] The doctrine is taken to postulate that any incidental or indirect interference with the functions of the Federal Government would make a State Legislation bad even though the legislation might relate to a subject allotted to a State Legislature and conversely. It is held that a State cannot tax the agencies or instrumentalities of the Federal Government and that a similar limitation applies as regards the Federal Legislature.

The doctrine has had many vicissitudes of fortune in the United States where subsequent judgments of the Supreme Court have tended to limit its scope. The position today is that the principle that 'possessions, institutions and activities of the Federal Government *itself*, in the absence of Congressional consent, are not subject to any form of State-taxation remains unshaken.[39] The same limitation applies to federal taxation in respect of the possessions, institutions and activities of State Governments. However, the exemption does not apply to taxation of individuals where the federation or a State is only indirectly concerned *i.e.*, where the incidence of the tax falls on private persons.[40]

Thus, exemption from State taxation has been denied to a contractor working for the federal Government or an employee of a Federal instrumentality. Similar exemption from federal taxation cannot be claimed in respect of employees of State Governments or of a business of a private nature conducted by a State. In Canada, the doctrine of immunity of instrumentalities has received a very limited recognition only. Thus, in *Jobin Deere Plow Co.*, V. *Wharton*,[41] the Privy Council held that the Dominion Parliament is competent, within its 'trade and commerce' power,[42] to incorporate companies and that :

> A province cannot legislate so as to deprive a Dominion company of its status and powers (or interfere with it)......in so far as that status and capacity carries with it powers conferred by Parliament of Canada to carry on business in every part of the Dominion.

[38] (1819) 4, Wheaton, 316.

[39] U.S. V. *Alighenny County* (1944) 322, U.S. 174(177).

[40] Wilmette Park District V. Campbell, (1949) 338, U.S., 411.

[41] (1915) A.C. 330.

[42] *British North America Act*, Section 91(2).

However, in Canada there is no immunity for Dominion or Provincial civil servants from Provincial or Dominion taxation respectively. The Constitution of Australia made a formal provision for a restricted form of mutual immunity by laying down : 'A State shall not...... impose any tax on property of any kind belonging to the Commonwealth, nor shall the Commonwealth impose any tax on property of any kind belonging to the States'.[43] As the Australian High Court has pointed out, this provision only refers to 'tax on property' and as such is a prohibition different from that contained in the American doctrine'.[44] The doctrine has, therefore, been very strictly interpreted. In two important cases[45] it was held that no exemption from Commonwealth customs duty could be claimed for goods (wire netting and steel rails in these two cases respectively) imported by State Governments from abroad.

In dealing with the issue of immunity of instrumentalities India's constitution-makers had the advantage of knowing the history of the doctrine in other federations. They were aware that, in view of the complications resulting from it, the doctrine had been greatly curtailed in scope in the United States and that it had been virtually abandoned in Canada and Australia. There was a vocal group of members in the Constituent Assembly, especially those from the erstwhile princely states, who argued in favour of incorporating in the Constitution the principle of full reciprocal immunity from taxation for both the Union and the States.[46] P. S. Nataraja Pillai even cited the report of the Indian States Finances Committee[47] in support

[43] *The Australian Constitution Act*, Section 114.

[44] *D. Emden* V. *Pedder* (1904) 1, C.L.R., 91.

[45] *King* V. *Sutton*, (1908) 3, C.L.R. 789 and *Attorney General of New South Wales* V. *The Collector of Customs* (1908) 5, C.L.R., 818.

[46] Refer, for example, to the speeches of P. S. Nataraja Pillai, *Constituent Assembly Debates*, IX, 30, pp. 1163-65, and S. V. Krishnamoorthy Rao (*Ibid.*, pp. 1165-66).

[47] The Committee had observed : 'We cannot... overlook the fact that if it should be enacted in its present form (that is, in the form of giving the right to the Centre to tax the State trade) it will have adverse consequences upon the finances of Indian States, to the extent that they are now dependent upon the tax-free income from these enterprises ; in some states such income is considerable. We recommend, therefore, that should article 266 be enacted in its present form, the *existing* State-owned and operated enterprises should be

of his amendment to draft Article 266 to the effect that 'provided that the trade or business which was carried on by or on behalf of the Government of a State before the commencement of this Constitution and any income accruing therefrom or arising therefrom shall not be liable to Union taxation'. While the arguments of these members did not cut much ice, the Constituent Assembly incorporated a modified and limited form of the principle in the Constitution. Rejecting the arguments advanced by the representatives of former princely states, Alladi Krishna Swami Ayyar declared that in view of the inevitability of socialisation of industries in India no blanket exemption from federal taxation could be guaranteed to state-owned and operated industries although some exemption may be warranted in the case of States like Mysore and Travancore. But, he contended[48] :

> On the other hand, to lay down a general principle of law that even at the present day before the provinces are on their feet every trade or business is exempt from taxation will lead to wild-goose schemes being started by various provinces. They may not take into account the general interest of trade and industry in the whole country. They may not have regard to the difference between one kind of industry and another.

The position, as finally laid down in the Constitution, is as follows. Under Article 285, the property of the Union is exempt from all taxes imposed by the States, save in so far as Parliament may provide otherwise. Articles 287 and 288 provide for special exemption from State taxation of electricity consumed by the Government of India or sold to the Government of India or in respect of water or electricity stored, generated, consumed, distributed or sold by any authority established by any existing law or by any law made by Parliament for regulating or developing any inter-State river or river valley.

Article 289 of the Constitution confers a limited reciprocal immunity from Union taxation on the States. It lays down that 'the property and income of a State shall be exempted from Union taxation'. However, in sub-clause (2) of this Article it is provided that

exempted from federal taxes on incomes to the extent to which they now enjoy such immunity. Vol. I, p. 47.

[48] *Constituent Assembly Debates*, IX, 30, 1169.

no such immunity applies to a trade or business carried on by, or on behalf of, the Government of a State or any property used or occupied for the purposes of any such trade or business, or any income accruing or arising in connection therewith (except any class of trade or business which Parliament may by law declare to be incidental to the ordinary functions of Government)[49].

There is some similarity between these provisions and the American doctrine of immunity of instrumentalities, but this similarity is partial. As the Supreme Court of India has pointed out, 'the general outline of Article 289 is based upon the American pattern that the property and income are not to be taxed, that trading is not an ordinary function of Government though Parliament may by law declare that any trade or business or any class of trade or business is incidental to functions of Government'[50]. However, 'there is no immunity in respect of the agents or instrumentalities of Government in our Constitution. The exemption is in respect of the 'property and income of a State'[51]. As far as 'instrumentalities' are concerned, the doctrine has been categorically rejected by the Supreme Court which has declared[52] :

> It was futile to attempt the resuscitation of the now exploded doctrine of the immunity of instrumentalities which, originating from the observations of Marshall C. J., in *M'Culloch* V. *Marlyland*, has been decisively rejected by the Privy Council as inapplicable to the interpretation of the respective powers of the State and the Centre under the Canadian and Australian Constitutions... and has practically been given up even in the United States.

It will be seen, thus, that the Constitution of India has given a strictly limited recognition to the doctrine of reciprocal immunity of instrumentalities. As Durga Das Basu has put it, 'the very inclusion in the Constitution of Articles 285 and 289 shows that the question of interference on the part of the Federal and State powers as against each other was not left to an "implied prohibition", and that outside

[49] *The Constitution of India*, Article 289 (3).

[50] Reference made by the President of India under Article 143 (1) of the Constitution (1964) II, S.C.J., 51.

[51] *State of West Bengal* V, *Union of India*, A.I.R., 1963, S.C. 1241.

[52] *Ibid.*

these provisions the Union and State legislatures have the full power to legislate on matters included within their respective lists, subject to the provisions of the Constitution'[53]. Our constitution-makers did not take a doctrinaire view but were influenced by realistic considerations. By not providing for complete mutual exemption from taxation and by not leaving the matter to be decided by the Courts, they ensured that India would be spared those problems which arose in the United States and to a lesser degree in Australia, from the rigid form in which the doctrine was originally propounded by the American Supreme Court[54].

[53] Durga Das Basu, *Commentary on the Constitution of India,* Vol. IV, 1963, Calcutta, p. 68.

[54] M. V. Pylee, *Constitutional Government in India,* Bombay, 1965, p. 618.

CHAPTER IV

FEDERAL FINANCIAL RELATIONS AT WORK

1. IMPACT OF PLANNING ON UNION-STATE FINANCIAL RELATIONS

OUR analysis of the pattern of Union-State financial relations established in the Constitution has led us to two definite conclusions. First, it was evident *ab initio* that the States would be in a position of relative inadequacy if they were to rely entirely on revenue resources enumerated in List II of the Seventh Schedule. With a view to removing this inadequacy without sacrificing State autonomy, the Constitution has made three provisions, *viz.*,

(*a*) assignment to the States of the proceeds of certain taxes to be levied or both levied and collected by the Centre ;

(*b*) sharing of the proceeds of income tax and Central excises between the Union and the States ; and

(*c*) Central grants-in-aid to the States under Article 275 (1) of the Constitution.

The procedure prescribed for the augmentation of the States' revenues through such transfer and devolution of funds is such that it does not adversely affect State autonomy. Our second conclusion was that the Constitution-makers felt that the total resources available to the States (through their exclusive resources and the resources obtained by them through tax sharing and Central grants under Article 275 (1) on the recommendations of an independent and impartial agency like the Finance Commission) would be reasonably adequate in meeting their normal obligations.

The actual working of federal financial relations in India over the past seventeen years has revealed, however, that the Constitution-makers were unable to anticipate and provide against the distortion of the constitutional pattern which has resulted from the advent of centralised national planning. It is not necessary, here, to examine in detail the position and role of the Planning Commission. It is necessary to note, however, that in the context of a

virtually monopolistic dominance of a single political party at the Centre as also in the States, national planning brought about a significant measure of uniformity of policy and administration in the economic field blurring the demarcation of responsibilities laid down in the Constitution. One need not go all the way with Santhanam in his oft-quoted statement : 'Planning has superseded the federation and our country is working as a unitary system in many respects'.[1] But, it is hard to deny the validity of Tarlok Singh's view that 'national planning widens the scope of the Centre and tends to reduce the distinction between Central and State responsibilities'.[2]

The Planning Commission has been described as a 'New Leviathan'[3] and a 'Super-Cabinet'[4] and is looked upon as the main instrument through which a steady shift of power to New Delhi has been manipulated. To put the picture in perspective, it is enough to say that this description perhaps corresponded to facts in the earlier years of planning but that in more recent years the States have come to play an increasingly assertive role in the formulation of the Plan, in the location of major public sector enterprises and in the allocation of funds. The National Development Council,[5] the highest advisory and reviewing body in the field of planning whose approval is obtained before the plan is presented to Parliament, is a forum in which the States have an important say. Despite the Centre's constitutional 'paramountcy' and political pre-eminence, planning in India is today based largely on methods of consultation and co-operation rather than those of pressure and dictation.[6] Planning is,

[1] K. Santhanam, *Union-State Relations in India*, Bombay, 1960, p. 56.

[2] Tarlok Singh, 'Administrative Relations in Planning', *The Indian Journal of Public Administration*, Vol. I, No. 2, p. 143.

[3] K. V. Rao, *Parliamentary Democracy of India*, Calcutta, 1965, p. 326.

[4] *The Radical Humanist*, Vol. xxiii, 6 December, 1959, p. 571.

[5] While the N.D.C. is, no doubt, the highest national forum in the sphere of planning, it is difficult to agree with Santhanam's description of this body as 'super-Cabinet of the entire Indian federation, a Cabinet functioning for the Government of India and the Governments of the States' (*op. cit.*, p. 47). As W. H. Morris-Jones points out, the fact that the N.D.C. is an advisory body meeting infrequently in brief sessions lasting a couple of days each 'rules out super-Cabinet as a label for it.' *The Government and Politics of India*, London, 1964, p. 142.

[6] W. H. Morris-Jones, *Parliament in India*, London, 1957, p. 10.

as a matter of fact, a joint responsibility of the Centre and the States even if the former has so far played a leading role. A shrewd observer has stated: 'I am favourably impressed by the extent to which State Governments in India participate in the Planning process'.[7] If the States have not been able to play their due part in the making of planning policy and in the formulation of the Plan, the fault lies partly with the States themselves. The failure arises from their lack of planning expertise and organisation. It is on account of this that the third Finance Commission made the suggestion that the States should establish their own planning apparatus with a view to undertaking a review, at suitable intervals, of the progress of the execution of plan targets and also other non-plan programmes.[8]

2. PLAN GRANTS AND LOANS

It is in the financial sphere that the real danger to state autonomy has developed and, to some extent, the States are themselves to blame for this situation. Planning, as we have suggested above, has seriously upset the financial balance of power established by the Constitution. This has resulted, in the main, from the increasing resort to discretionary 'plan' grants under Article 282 of the Constitution. This Article, as Santhanam has pointed out, was inserted in the Constitution as a residuary provision and was not intended to be one of the major provisions for making financial adjustments between the Union and the States.[9] Elaborating the point, he has expressed the view that 'the Article was intended to give power to the Union and the States to make grants for special bodies and purposes like the U.N. and other international bodies and to any State in case

[7] Arthur W. Macmahon, *Delegation and Autonomy*, Bombay, 1961, p. 70.

[8] *Report of the Third Finance Commission*, 1961, p. 43. Acting on this suggestion some States have set up Planning Boards. Unfortunately, however, these Boards cannot compare with the Planning Commission either in regard to the political standing or professional competence of their members. In most cases, State Planning Boards are mere Committees of department officials.

[9] K. Santhanam, *op. cit.*, p. 40. According to Asok Chanda, the Article 'was obviously intended to be no more than a permissive provision to meet a situation not otherwise provided'. *Federalism in India*, London, 1965, p. 185.

of serious natural calamities like famine, floods or earthquake'.[10] How little importance was attached to this Article by the Constitution-makers may be seen from the fact that it was adopted by the Constituent Assembly without any discussion. For the normal budgetary difficulties of the States, Central grants-in-aid under Article 275(1) were expected to serve as the main instrument for the necessary devolution of funds. The advent of Planning has entirely changed the expected situation. Article 282 has become the back-bone of federal planning finance'[11] and has provided the basis for progressively massive grants made by the Union Government to the States for the implementation of centrally sponsored plan projects. Though this Article figures in the section dealing with 'Miscellaneous Financial Provisons', 'it is being extensively used to regulate financial relations between the Union and the States......All capital grants to the States by the Union for implementing their respective shares of the Five Year Plans are now made under this Article as falling within the scope of 'public purpose'.[12]

The trouble with 'plan' grants is that they are 'discretionary' in the sense that they are issued by different Union Ministries on the recommendations of the Planning Commission which, unlike the Finance Commission, is neither independent nor impartial but an adjunct of the executive machinery of the Union Government.[13] Besides, these grants are, normally, of a 'matching' variety, the States being required to contribute a share in accordance with a stipulated percentage of the Central grant. Further, these grants have 'strings' attached to them in so far as they involve varying measures of Central inspection and supervision of their use. These grants also involve encroachment of State autonomy as the settlement of the amount of these grants and, later, their actual issue depends upon detailed dis-

[10] K. Santhanam, 'Federal Financial Relations', *Commerce*, 5 November 1966, p. 798.

[11] W. H. Morris-Jones, *op. cit.*, n. 5, p. 143.

[12] Asok Chanda, *op. cit.*, p. 185.

[13] In a minute appended to the *Report of the* (Fourth) *Finance Commission*, 1965, Dr. P. V. Rajamannar, Chairman, observed, 'When compared to a statutory body like the Finance Commission, which is quite independent of the Government, the Planning Commission may be described as quasi-political' (p. 90), and urged that 'the Planning Commission may be given the status of an independent, permanent statutory body' (p. 92).

cussions between the State Governments, the Planning Commission and the Central departments concerned.[14] Finally, these grants are available only for the plan period at the end of which they become committed expenditure for which the States are exclusively responsible. Naturally, they approach the Finance Commission and try to get a greater share of the revenue and larger grants. This constitutes a vicious circle.[15]

That these 'plan' grants spell encroachment on State autonomy becomes clear when it is noted that they are given to the States in respect of a large variety of matters which fall within the area of exclusive States jurisdiction. For example, the Union budget for 1959–60 provided for matching grants in respect of 60 items including general and technical education (Rs. 20 crores), community development and national extension services (Rs. 17 crores), agriculture and fisheries (Rs. 8 crores) and malaria eradication (Rs. 7.5 crores). The technique of matching contribution by the States and supervision of the utilization of these funds by central agencies open the door to central intervention in a sphere which the Constitution has reserved exclusively to the States. The Union Ministries which release these grants are, naturally, in a position to exercise some control over corresponding ministries in the States. Some observers have gone to the extent of saying that this control is so extensive that each Union Ministry concerned with 'State' subjects may be said to have become a sort of an empire with corresponding State Ministries as feudatories. Referring to the Union Ministry of Community Development, P. R. Dubashi writes :[16]

> Over the years the Union and State organisations have worked in such great unison that the Union Ministry has found it possible to use the State organization as almost its direct operational instrument rather than as a distinct administration of an autonomous unit of a federal structure.

The important part played by 'plan' grants in giving a new slant to Union-State financial relations in India may be stressed by

[14] K. Santhanam, 'Federal Financial Relations', *Commerce*, 12 November 1966, p. 847.

[15] *Ibid.*

[16] P. R. Dubashi, 'Unitary Trends in a Federal System', *The Indian Journal of Public Administration*, Vol. VI, No. 3, 1960, p. 250.

noting the snow-balling increase in the quantum of these grants. The total amount of these grants during the first plan period was Rs. 133 crores. During the second Plan period it rose to Rs. 461 crores. It was of the order of Rs. 821 crores during the third plan period.[17] The relative position of 'plan' grants in comparison with the grants made on the recommendations of the Finance Commission under Article 275(1) of the Constitution as also with the total devolution of funds is brought out in the following table :

FINANCIAL DEVOLUTION FROM CENTRE TO STATES

(in crores of rupees)

	First Plan	Second Plan	Third Plan
Share of divisible taxes and duties	324	527	723
Taxes and duties wholly accruing to States	2	184	190
Total shared taxes	**326**	**711**	**913**
Grants met from revenue	248(41)*	668(165)*	912(226)*
Grants met from Capital	40	78	100
Total Grants	**288**	**746**	**1012**
Loans	799	1411	2208
Grand Total	1413	2868	4113

* Figures within brackets show the amounts determined by the Finance Commission.

The position may also be stated in a somewhat different fashion. Out of the total revenues of the States of Rs. 7,314 crores in the Third Plan period, the grants given on the recommendations of the Finance Commission under Article 275 (1) accounted for only 4.9 per cent, while plan grants made without reference to the Finance Commission, and of which the bulk was given under Article 282 of the Constitution, accounted for 13 per cent. It is thus clear that not only have discretionary plan grants been far more substantial than grants made under Article 275 (1) but that they are far larger than the total assistance afforded under the provisions governing the 'distribution of revenues between the Union and States'.[18] As one

[17] K. Santhanam, *op. cit.*, n. 14, p. 487.

[18] Asok Chanda, *op. cit.*, p. 186.

expert has contended[19]:

> The increasing reliance of States on discretionary Central grants has naturally led to a situation in which the constitutional division of functions between the Centre and the States is getting blurred, and the Centre is able increasingly through the mechanism of grants to influence State administrative nature in fields such as education and public health.

The growing dependence of the States on Central assistance and the resulting threat to their autonomy has been aggravated by loans advanced to the States by the Centre mainly for meeting the capital expenditure required for the implementation of plan projects. Before the era of Five Year Plans, Central loans to the States were of a very small order. When India became independent, the total loans the Provinces owed to the Centre amounted to a mere Rs. 44 crores. By 31st March, 1951, that is on the eve of the launching of the First Five Year Plan, the amount had risen to Rs. 195 crores but this is accounted for by the loans issued to the Provinces to enable them to meet the unprecedented problem of the rehabilitation of displaced persons from Pakistan. During the First Five Year Plan, loans of the order of Rs. 799 crores were issued to the States. This rose to Rs. 1,411 crores during the Second Plan. During the Third Plan, the debt liability of the States to the Centre had touched the astounding level of Rs. 3,100 crores.[20]

Now Central loans to the States are closely linked with plan grants under Article 282 and are ear-marked for specific projects. Theoretically, the States are under no obligation to ask for or accept these loans. But they can exercise this theoretical freedom only by foregoing the development projects for which they are offered or granted. Politically, the States are unable o exercise their 'legal' freedom. They cannot afford to be left behind in a competitive process of economic development. The fact is that, whether they like it or not, the States undertake schemes relating to matters within the sphere of their exclusive jurisdiction although the schemes are formulated, sponsored and sometimes directed by Union agencies. Central loans, like plan grants, have accordingly : come an impor-

[19] G. Ramchandran, 'Union State Relations in Finance and Planning', *The Indian Journal of Public Administration*, Vol. XII, No. 3, p. 379.

[20] These figures are cited from K. Santhanam, *op. cit.*, n. 14, p. 847.

tant lever for the projection of Central authority into the region of State autonomy. Understandably, the growing indebtedness of States to the Centre is a matter which is causing considerable worry to all concerned. Taking note of the fact that the States are becoming dependent on the Centre on an ever-increasing scale, the third Finance Commission observed : 'This increasing dependence is diluting, on the one hand, the accountability of State Cabinets to their legislatures ; on the other, it is coming in the way of the development of a greater sense of responsibility in their administration'.[21]

It is evident that, to some extent, the financial lever has been used to trench upon the sphere of State autonomy. Through financial inducements, the Centre has often been able to influence not only the over-all targets and priorities of State plans but to persuade State Governments into particular channels of social service activities sponsored by it but not necessarily desired by the States. Complaints have occasionally been made by State Governments on this score. Thus, in a memorandum submitted by the West Bengal Government, it was pointed out that during the period 1957–58 to 1960–61, the growth of Central expenditure had been relatively greater on subjects in the State List than on those in the Union List. The memorandum expressed disapproval of the tendency of the pattern of Central assistance to be utilised by the Union Government and the Planning Commission to influence priorities in the State sector or to super-impose a system of priorities which may have no relevance to the conditions prevailing in different States. By way of an illustration of this tendency, the West Bengal Government mentioned that it had been asked 'to undertake measures for the control of filaria in West Bengal where this disease was unimportant but could not qualify for Central assistance by implementing a leprosy scheme to which the State Government attached greater importance'.[22] That Central planning in matters primarily within the sphere of State responsibility often leads to wasteful attempts at uniformity was highlighted by the 'basic education' scheme. State Governments were pushed by political pressure and financial baits into accepting the scheme although many of the State-Governments

[21] *Report of the* (Third) *Finance Commission*, 1961, p. 37.

[22] Asok Chanda, *op. cit.*, pp. 284–85.

had no faith in and little enthusiasm for it.[23] What offers of financial assistance and the use of other devices of 'guidance' and co-ordination can do to bring about a blurring of the lines of responsibility and power drawn in the Constitution has been brought out clearly by P. R. Dubashi in a previously quoted study of Union-State relations with respect to the community development programme. He states: 'It will be reasonable to conclude that in an exclusively State sphere of activity, the Union Government has effectively stepped in as a partner and that too as a senior partner'.[24]

Lest planning should appear to be too much of a villain of the piece in our analysis, it should be pointed out that planning has led to important national gains which would have been impossible without the control exercised by the Centre through discretionary assistance. This aspect of the matter may be stated in a somewhat extended citation from a recent study of federal financial relations in India made by G. Ramachandran, a former Finance Secretary to the Government of Madras. He observes:[25]

> In so far as the Plan seeks to promote certain national priorities and objectives, some sacrifice of independence of action on the part of the States cannot be helped. One should in fairness also concede that planning, while limiting the freedom of action of the States, has helped to promote uniform policies calculated to aid economic growth and has imposed a measure of discipline on the States in regard to control of non-planned non-developmental expenditure. The States have also been persuaded to undertake various measures for mobilization of resources on a scale which, left to themselves, they may not have undertaken. To this extent, the powerful control exercised by the Planning Commission through discretionary Central assistance for economic development has helped to raise the rate of capital formation in the country. Discretionary grants-in-aid within the framework of the Plan have been a mechanism through which resources have been diverted to comparatively backward States and have thus helped to bring about a measure of equalization in standards of social services and economic development.

[23] K. Santhanam, *op. cit.*, n. 1, p. 50.

[24] P. R. Dubashi, *op. cit.*, pp. 254–55.

[25] G. Ramchandran, *op. cit*, p. 379.

While this must be recognised, it remains true that the ever-growing dependence of the States on the Centre is likely to subvert the federal character of our Constitution. The situation is developing into a vicious circle which must at some stage be broken if the States are to exercise the minimum autonomy consistent with the principles of federalism. To some extent, the increasing dependence of the States on the Centre is inherent in the very scheme of the division of responsibilities between the Centre and States for economic development under the plan.[26] We have seen that a large part of the Central expenditure on plan projects in the State sector (both on revenue and capital accounts) is concerned with schemes relating to agricultural production and welfare services such as education, Harijan uplift and medical relief. Besides, outlays in the Central sectors tend generally to be made on productive projects such as development of minerals, heavy industries, transport and communications which may, in course of time, bring in substantial revenues. Projects in the State sectors are by and large non-productive and initial Central assistance helps only to add to the financial liabilities of the States. The Centre's resources base is automatically broadened by the growth of national income in general and by the growth of production-organised industry in particular. In view of this built-in feature of Indian planning, 'the very process of development thus entails increased revenues to the Centre and greater liabilities to the States'.[27]

3. FINANCIAL IMBALANCE AND THE RESPONSIBILITY OF STATES

We have said enough to show that under the impact of Planning, the financial equation is moving inexorably to the disadvantage of the States due mainly to the Centre's policy of providing financial assistance to the States far more in the form of loans and discretionary grants under Article 282 of the Constitution than through statutory devolution of resources and grants under Article 275(1) on the recommendations of the Finance Commission. Having said this, it is necessary to point out that the States must themselves bear part of the blame for the aggravation of the imbalance resulting from constitutional provisions and the consequent erosion of State

[26] *Ibid.*, p. 380.
[27] *Ibid.*

autonomy. Central inroads on the sphere of exclusive State jurisdiction have resulted, at least partly, from the relative inefficiency of State Governments and their inability or unwillingness, for political rather than fiscal reasons, to develop and tap their own tax resources with sufficient vigour.

On the contrary, they are inclined to take the easy line of expecting the Finance Commission to help them by recommending greater transfer of funds for them or of simply bartering away their independence for Central munificence. The Finance Commission has shown commendable concern for the States. All the same, it has declared that :[28]

> Secure in the knowledge that the annual budgetary gap would be fully covered by devolution of Union resources and grants-in-aid, the States are tending to develop...an allergy to tap resources in the rural sector on many considerations and also a disinclination to make up the lee-way in others.

In the same report, the Commission has noted that the undesirable results of the reluctance of State Governments to fully exploit their own tax resources are aggravated by inadequate attention to expenditure control. The Commission has observed :[29]

> Though it is generally accepted that the rural sector could make a greater contribution to the national economy, there is an understandable reluctance to revise even the rates of land revenue in operation even when they have not been reviewed in the last 30 to 60 years. In one State when a limited operation indicated that the rates could be raised considerably on an old, accepted and established principle of assessment, the Government considered it inadvisable to continue the settlement operations. In another State, in real need of resources, the collection of betterment levy already introduced had to be suspended just because the neighbouring State had done so in a more prosperous contiguous area. All these induce a chain reaction of enforced under-taxation on one hand and avoidable increase in public expenditure on the other.

These comments become particularly meaningful when one notes that a number of State Governments have declared their inten-

[28] *Report of the* (Tbird) *Finance Commission*, 1961, p. 38.

[29] *Ibid.*, pp. 38-39.

tion to abolish the land revenue. The inadequacy of tax effort on the part of State Governments has been a recurring subject of adverse comment without any sign of improvement in the situation. Except in a few States, there has been a marked tendency to shy away from unpopular imposts. This is illustrated, among other things, by the actual collection of betterment levy by the States. Urban property is an easy target, but taxing farm incomes is difficult, for popular governments dare not displease the rich and middle peasants on whose electoral support they heavily rely. Commending a proposal recently made by the Punjab Kishan Sabha for a single tax on agricultural incomes based on a slab system and with exemption for farmers with holdings of less than five acres, the *Indian Express* wrote in an editorial : 'It has been evident for quite some time that the framework of agricultural taxation needs to be revised in the context of the nation's effort to accelerate its rate of economic growth. One of the specific measures which the Centre has constantly proposed and the States have assiduously resisted is a tax on agricultural incomes.'[30] A suggestion that agricultural income tax should be assimilated to the general scheme of income tax was pooh-poohed not because the yield would be low (which was a fact) but because it might be the thin end of the wedge of higher taxation of farm incomes.[31] At a meeting of the Standing Committee of the National Development Council held on 18 January, 1963, Union Planning Minister, G. L. Nanda, deplored the fact that the States were lagging behind in regard to additional taxation to which they had earlier committed themselves.[32]

It is only in view of the situation described above that we can see the criticism that 'every State has become a petitioner at the doorstep of the Central Government'[33] in the correct perspective. If national planning has created financial problems for the States, the latter are to no small extent themselves responsible for their predicament. In the sort of horse-trading that marks the bargaining between State Governments and the Planning Commission, the former indulge in competitive improtuning, each trying to obtain the largest possible plan allocations by overstating their revenues, under-stating their

[30] *The Indian Express*, 2 December, 1965, p. 6.

[31] *The Hindustan Times* (*Editorial*), 10 November, 1963, p. 7.

[32] *The Indian Express*, 19 January, 1963, p. 1.

[33] K.M Panikkar, *The Foundations of New India*, London, 1963, p. 238.

expenditure and giving an unduly rosy picture of the additional resources they can raise.[34] Once the bargain is made, the general tendency on the part of the State Governments is to drag their feet over the financial commitments voluntarily accepted by them and to transfer to the Centre a much greater financial burden than originally settled. Not only are the States able to manipulate this financial leverage to the discomfiture of a supposedly all-powerful Centre but they are often able to distort agreed priorities and divert funds from specified schemes in spite of the streamlining of procedures carried out in 1958 and subsequently. Divorce between power and responsibility is one of the results of this process. If, as Morris-Jones says, politically sensitive State Governments 'will always be tempted to barter away the responsibilities of freedom for the comforts of support even with strings attached',[35] it needs to be stressed that the subordination of the States alleged to be caused by national planning often tends to be exaggerated. The States have, in fact, come to expect financial assistance from the Centre as a matter of course and manage, through various forms of fiscal juggling, to transfer to the Centre a disproportionate burden of financing the plans.

This is not to say that there is no State dependence on the Centre for financial support. The important point to note is that a large part of this dependence is due to the failure of State Governments to observe the canons of sound budgeting and financial discipline. It is a patent fact that, apart from development expenditure, there has been an immense rise in the revenue expenditure of States on non-development activities during the past decade and a half. Taken as a whole, there has been a 400 per cent rise in the revenue expenditure of States between 1951–52 and 1964–65. Non-development expenditure has registered phenomenal increase. In the first year of the Second Plan (1956–57), it constituted 30.6 per cent of the total revenue expenditure of States. In the first year of the

[34] W. H. Morris-Jones, *op. cit.*, p. 144.

[35] It is not suggested that the Union Government is a model of financial discipline. The emphasis is laid here on the States since we are dealing with the reasons for their growing dependence on the Centre. On the need of financial discipline on the part of Union as well as State Governments, see K. Santhanam, 'Financial Discipline for Union and State Governments', *The Indian Journal of Public Administration*, Vol. XII, No. 3, pp. 499–503.

Third Plan, it stood at 39.1 per cent.[36]

What is really disturbing is that this rise is, in no small measure, the result of ever-proliferating offices and increase in the number of Government employees. Not long ago, it was officially estimated in Uttar Pradesh that 15 per cent of the Government staff was surplus. Much the same is true of other States too. But with retrenchment politically difficult and with growing agitation for better emoluments, the difficulties of State Governments constantly multiply.

The tendency of State Governments to leave their budgets unbalanced and to hope that the Finance Commission would solve their problems by recommending greater devolution of Central resources has become well-known. Wasteful expenditure appears to have become a settled habit with most State Governments. The frequent resort to overdrafts on the Reserve Bank of India has drawn repeated and public censure but ways have still to be found to put an end to this unhealthy practice. More often than not the Centre is obliged to advance loans to the States to pay off their overdrafts.[37] The imperative need to balance State budgets has been stressed time and again. A typical example was the conference of State Chief Secretaries held in July 1966 at which S. Boothalingam, Union Economic Affairs Secretary, drew pointed attention to the difficulties created by State overdrafts[38] on the Reserve Bank and recalled the repeated advice of the Centre to the States to substantially reduce their expenditure and ensure balanced budgets.[39] A little earlier, the matter was debated in the *Rajya Sabha* and the need for curbs on the States in the matter of overdrafts was stressed. Referring to the ever increasing extravagance of the States as 'rake's progress', Swatantra M.P., M. Ruthanswamy wondered why it was not possible

[36] *The Times of India*, 30 July 1966, p. 4.

In absolute terms non-development expenditure has increased from Rs. 1,115 crores in the First Plan to Rs. 3,246 crores in the Third Plan. *Reserve Bank of India Bulletin*, May 1966, p. 461.

[37] *The Indian Express*, 18 January 1966, p. 6.

[38] Not unoften the States blame the Centre for forcing them to resort to R.B.I. overdrafts. According to an official spokesman of the Madhya Pradesh Government, State overdrafts are the result of schemes taken up by State Governments entirely or partly on behalf of the Centre and the failure of the Union Government to release funds in time.

[39] *The Hindustan Times*, 20 July 1966.

for the Centre to exercise greater control on the States specially when the same party was in power at the Centre and in the States.[40] There is no wonder, therefore, that a recent plea for greater financial autonomy for the States advanced by Rajasthan Finance Minister, Balkrishna Kaul, made little impact. Commenting on his demand, *The Hindustan Times* stated editorially : 'The expenditure record of the States has not been one to convince the general public that there is a case for greater financial autonomy for the States'.[41] While it would be unfair to suggest that the Union Government has a distinctly better record, the point to remember is that it is the autonomy of the States that is at stake. To safeguard further erosion of their financial independence, which is the key to their independence in the legislative and administrative spheres, it is evidently in the interest of the States themselves to improve their house-keeping.

[40] *The Hindustan Times*, 23 March 1966.
[41] *The Hindustan Times*, 2 July 1966.

CHAPTER V

THE FINANCE COMMISSION : NATURE AND SCOPE

1. THE NEED FOR A FINANCE COMMISSION

IF our discussion in the preceding chapters has helped to bring out any positive conclusion it is that the most difficult problem of federalism is that of devising a satisfactory distribution of financial resources between the general and regional governments. As Chanda has pointed out, 'in no federation has it been possible to provide for allocation of resources to correspond with the allocation of functions'.[1] No matter how carefully and elaborately a federal constitution lays down the distribution of resources, the resulting balance of power is bound to be slanted in favour of one or the other level of government. Even if the distribution is initially equitable, the passage of time and changes in the economic situation tend to disturb the equilibrium. In practically all cases, the constitutional division of revenue resources places the federal government in a stronger position and leaves the component units with means inadequate for meeting their manifold and expanding responsibilities. As a general rule, 'a chronic gap between the own resources and expenditure potential of the States seems to be an inherent feature of all well-established federations'.[2] The gap tends to vary with time and circumstances. Hence the need for flexible balancing devices for effecting adjustments in federal financial relations. 'The problem of federal finance', says D.R. Gadgil, 'is thus that of maintaining, through changing circumstances, needed correspondence between functions and resources without the use of any coercive power'.[3]

The Indian Constitution is no exception to the general problem

[1] Asok Chanda, *Federalism in India*, London, 1965, p. 188.

[2] D. T. Lakdawala, 'The Four Finance Commissions in India', *The Indian Economic Journal*, Vol. XIII, No. 4, 1966, p. 498.

[3] D. R. Gadgil, *Planning and Economic Policy in India*, Bombay, 1965, p. 294.

of federal finance mentioned above. Despite elaborate and detailed provisions for the division of financial resources between the Union and the States, the framers of the Constitution realised that no distribution, however carefully made, could be satisfactory at all times and under all circumstances. They realised, further, that the problem of federal financial relations becomes particularly complicated in a developing economy such as that of India where the development of social services and welfare activities is primarily the responsibility of the States while the more productive and elastic tax resources are assigned to the Centre. Accordingly, they were aware that the adjustment of Union-State financial relations is a recurring problem. They took into account the possibility of States lacking adequate funds to be able to cope effectively with their growing responsibilities and laid down provisions for the devolution of resources through the transfer of a part of the proceeds of certain Union taxes to the States and through Union grants-in-aid of the revenues of the States. The Constitution provides for both obligatory and permissive tax sharing.[4]

Arrangements for transfer of resources from the general to the regional governments have been developed in all federations. The trouble, however, has been that in most cases these transfers have taken the form of discretionary and conditional federal grants to the component units. 'As there was no constitutional provision for assistance or for sharing the yield of specified taxes, the grants made were entirely discretionary in character',[5] the only exception being the grants made in Australia on the recommendations of the Commonwealth Grants Commission. In older federations, there has been considerable criticism of these grants on the ground that they tend to be arbitrary and that they are often disbursed on political rather than economic or fiscal considerations. Inevitably these grants involve federal encroachments in fields of activity placed by the constitution under the exclusive jurisdiction of the regional governments.

[4] Proceeds from the general income tax have to be shared between the Union and the States, the only point to be determined being the percentage to be given to the States. Proceeds from excise duties are to be shared if Parliament by law so provides.

[5] Asok Chanda, *op. cit.*, p. 189.

Indian constitution-makers were anxious to avoid such a situation arising in this country. The Indian Constitution can, in fact, claim the merit of having instituted an independent agency on the recommendations whereof substantial transfers of Union resources can be made without adversely affecting State autonomy. This agency is the Finance Commission. To quote Chanda, 'the provision of a Finance Commission is intended to assure the States that the scheme of distribution will not be made by the Union arbitrarily but will be based on the recommendations of an independent commission which will assess the changing needs of the States in making them.'[6] It is 'to obviate the frequent political pressures to which the Parliament and the Cabinet are likely to be subjected in revising the system of Union-States transfers, that the Indian Constitution provides for the appointment of a Finance Commission whose recommendations must be taken into account in deciding the grants-in-aid of the States' revenues, the sharing of taxes and other matters referred to it.'[7]

The Finance Commission which is the main departure in the financial provisions of the Constitution from the scheme of the Government of India Act, 1935,[8] is 'an innovation of far-reaching importance to the working of the Indian federal system.'[9] B. N. Rau, constitutional adviser to the Constituent Assembly, described the Finance Commission as 'a quasi-arbitral body whose function is to do justice between the Centre and the States.'[10] The Chairman of the Drafting Committee, B. R. Ambedkar, visualized the commission's role in almost exactly the same terms *viz.*, 'to do justice between province and province and between the Centre and the provinces.''[11] T. T. Krishnamachari also declared that the purpose behind the creation of the Finance Commission was 'to assure the

[6] *Ibid.*, p. 189.

[7] D. T. Lakdawala, *op. cit.*, p 50.

[8] *Report of the Taxation Enquiry Commission, 1953–54*, Government of India, Ministry of Finance, 1955, para 10, p. 7.

[9] K. R. Bombwall, 'The Finance Commission and Union-State Relations in India', *The Indian Journal of Public Administration*, Vol. X, No. 2, p. 278.

[10] B. N. Rau, *Indian Constitution in the Making*, Madras, 1960, pp. 384–85.

[11] *Constituent Assembly Debates*, IX, 7, p. 260.

States that they will have a fair deal.'[12]

The role of an independent and impartial tribunal to judge between the conflicting claims of the Union and the States in a specified sphere of federal finance which the Constitution assigns to the Finance Commission makes it a somewhat unique institution. No other federal constitution offers an exact parallel to it. The only close analogy is the Commonwealth Grants Commission of Australia which was created in 1933, under the acute strains and stresses of the great depression. It was established by the Commonwealth Government acting in its executive capacity. In other words, it has no constitutional basis and is 'only a piece of administrative machinery similar to the *ad hoc* machinery that has been devised by the Government of India on varying occasions, namely, Conference of Premiers of various States, Conference of Finance Secretaries, and so on.'[13] The Indian Finance Commission, on the contrary, is the creation of the Constitution. It is true, as T. T. Krishnamachari explained in the Constituent Assembly, that 'the idea of the Finance Commission is a very restrictive one.'[14] All the same, the scope of its work is distinctly wider than that of the Australian Grants Commission. The latter has no power to suggest changes in tax sharing or the basis for distribution among States *inter se*. The only regular function assigned to it is to determine the quantum of special federal grants to the three 'claimant' States, namely, Western Australia, Tasmania and South Australia. Occasionally, the Commission has also recommended additional payments to these States under Section 6 of the Uniform Tax Law, but these payments may correctly be regarded as a part of the special grants procedure and they do not add to the Commission's competence. As H. P. Brown pointed out some years ago, no attempt has been made to seek the Commission's recommendations in regard to any grants other than the special grants and the grants under Section 6 of the Uniform Tax Legislation.[15] The Indian Finance Commision has relatively

[12] *Ibid.*, IX, 9, p. 326.

[13] *Ibid*, IX, 9, p. 325 (T. T. Krishnamachari). It should be stated here, however, that the Australian Commission is a standing body whereas the Indian Finance Commission is an *ad hoc* agency appointed every five years or so.

[14] *Ibid.*, p. 326.

[15] H. P. Brown, 'Some Aspects of Federal-State Financial Relations',

wider functions to discharge. Apart from making recommendations regarding the sharing of the proceeds of general income tax and Union excises between the Union and the States and the distribution of the States' share *inter se*, it has the power to recommend general and specific grants-in-aid of the States' revenues. Thus the first Finance Commission recommended grants for the promotion of primary education to some States. In the same way, the third Finance Commission recommended that a sum of Rs. 36 crores (approximately equal to 20 per cent of the proceeds of the excise duty on motor spirit) be distributed among the States for improvement of communications. Evidently, the functions of the Finance Commission of India are more comprehensive than those of the Australian Commonwealth Grants Commission. The difference between the two Commissions may be seen from the fact that while in 1954–55 the Australian Grants Commission controlled less than 6 per cent of the federal-state transfers, the Indian Finance Commission deals with 30 to 35 per cent of such transfers.

2. COMPOSITION, FUNCTIONS AND POWERS OF THE FINANCE COMMISSION

Under Article 280 of the Constitution, the President of India is required to appoint a Finance Commission, consisting of a Chairman and four members, within two years of the commencement of the Constitution and thereafter every five years or earlier. In keeping with this requirement the first Finance Commission was set up in 1951, the second in 1956, the third in 1960 and the fourth in 1964.[16] Further, the Constitution empowers Parliament to determine the qualifications of the Chairman and members of the Finance Commission and the manner of their selection and to prescribe the powers of the Commission for the performance of its functions. Parliament enacted the Finance Commission (Miscellaneous Provisions) Act in 1951 to deal with these questions. And it is under this legislation (as amended in 1955) that the successive Finance Commissions have been established.

in Geoffrey Sawer (Ed.), *Federalism, An Australian Jubilee Study*, Melbourne, 1952, p. 52.

[16] These Commissions submitted their reports in 1952, 1957, 1961 and 1965. The fifth Finance Commission has been set up recently and is expected to submit an interim report in July 1963.

According to the qualifications laid down in the Finance Commission Act, the Chairman of the Commission must be a person who has had experience of public affairs and its members should be persons who :

(*a*) are, or have been, or are qualified to be appointed as judges of a High Court ; or

(*b*) have had wide experience in financial matters and in administration, or

(*c*) have special knowledge of the finances and accounts of the Government ; or

(*d*) have special knowledge of economics.

The practice has been to appoint a prominent public man as Chairman and to include among members at least one person who may be said to represent the States' point of view, one eminent economist and a senior official of the Union Finance Ministry as Secretary-Member of the Commission.[17]

The functions of the Finance Commission are laid down in Article 280(3) of the Constitution. At present, the Commission is required to make recommendations to the President of India as to :

(*a*) the distribution between the Union and the States of the net proceeds of the taxes which are or may be divided[18] between them and the allocation between the States of the respective shares of such proceeds ;

(*b*) the principles which should govern grants-in-aid of the revenues of the States out of the Consolidated Fund of

[17] For instance, the first Finance Commission had K. C. Neogy, a former member of the Union Cabinet, as Chairman and included an ex-Finance Minister of a State, a retired High Court Judge and an economist as members and a Union Finance Ministry official as member-secretary.

[18] The First Finance Commission interpreted the words 'may be divided' to mean that, in addition to income tax, it could make recommendations in respect of excise duties which, according to the Constitution, *may be* shared with the States if Parliament so decides by law. Neither the Constitution nor the terms of reference of the Commission required specifically that Parliament's discretion in this regard should be exercised after considering the recommendations of the Finance Commission. The Commission, however, took the view that it could make recommendations to the President of India even though they could not be implemented without parliamentary legislation. This point of view has come to be accepted.

India ; and

(*c*) any other matter referred to the Commission by the President in the interests of sound finance.

The actual work assigned to a particular Finance Commission is spelt out in the terms of reference specified in the Presidential order setting up the Commission. In any case, the investigations and recommendations of the Finance Commission do not cover the entire field of Union-State financial relations. This is neither necessary nor practicable. A quinquennial review of these relations as a whole is evidently uncalled for. Thus the Constitution has kept the exclusive tax revenues of the States outside the Finance Commission's purview. Nor is the Commission empowered to recommend alterations in the constitutional distribution of tax resources between the Union and the States[19]. Again, the Finance Commission is not competent to make recommendations as regards the discretionary plan grants and central loans to the States[20]. Within these limitations, the scope of the Finance Commission's work can be extended under the clause 'any other matter referred to the Commission by the President in the interest of sound finance'.

The Finance Commission has the status and powers of a civil court in the matter of summoning and enforcing the attendance of witnesses, requiring the production of documents and calling for public records from any office or court. The Commission is empowered to call upon any person to furnish information on such points or matters as in the opinion of the Commission may be useful for or relevant to the matter under its consideration. Any person so required is under a legal obligation to furnish information within the meaning of Section 176 of the Indian Penal Code. The Commission is further authorised to determine its own procedure of

[19] It is interesting to note that the Chairman of the Fourth Finance Commission has suggested, in a separate minute, that the tax shares and the general principles governing their distribution among the States should be embodied in the Constitution.

[20] It is debatable whether the Finance Commission is competent to recommend planning grants on revenue account. The Fourth Finance Commission appeared to think the Commission could do this. *Report of the (Fourth) Finance Commission*, 1965, para 19, p. 9. Minute by Dr. P. V. Rajamannar, paras 8-9, pp. 88-89.

business. The Finance Commissions so far constituted have followed the practice of visiting the States, holding consultations with Ministers and senior officials of the Union and State Governments and receiving memoranda and oral evidence from individuals and representatives of interested organisations before formulating their recommendations to the President of India.

The Finance Commission is an advisory body and the President is not bound to accept its recommendations. As M. Ananthasayanan Ayyangar put it in the Constituent Assembly, 'The Finance Commission's recommendations are only recommendatory and not obligatory.'[21] It was, however, recognized by the constitution-makers that the creation of such an institution in a federal state would lose all meaning if its recommendations were not to be accepted by the President except only where they had to be turned down for considerations of overriding national importance. Such rejections would be an exception rather than the rule. Hriday Nath Kunzru expressed the hope 'that a convention will grow up that the Government should normally, that is except in emergencies, accept the recommendations of the Commission.'[22] In his lectures on the Indian Constitution, delivered at the University of Madras in 1953, the late Sir Ivor Jennings spoke rather sceptically about the Union Government's attitude towards the Finance Commission. He observed :

[21] *Constituent Assembly Debates*, IX, 9, 324.

[22] *Constituent Assembly Debates*, IX, 7, p. 258. It is interesting to note that there was a certain amount of misunderstanding in the Constituent Assembly regarding the role of the Finance Commission. Some members like K. T. Shah feared that the Finance Commission was so much more additional patronage in the hands of the executive and that it would take away part of the powers of Parliament. *Constituent Assembly Debtates*, IX, 9, p. 321. Others like H.V. Kamath, Shibban Lal Saksena and B. N. Munnavalli, who agreed with him, insisted that all recommendations of the Commission should require parliamentary approval. Even Kunzru was in favour of limiting the Commission's role to the making of recommendations in regard to Union grants-in-aid of the revenues of States. But Dr. Ambedkar who stoutly justified the wider competence conferred on the Finance Commission declared that 'in the action to be taken by the President, he should be guided by the recommendations of the Fiscal Commission and should not act arbitrarily'. (*Constituent Assembly Debates*, IX, 7, p. 261). B.N. Rau also held that, except in case of patent error, 'no Ministry should advise the President to depart from the recommendations of the Commission', *op. cit.*, p. 384.

'These matters are not decided by Commissions......The problem is almost invariably one of vote. Commissions propose, but politicians dispose and politicians depend on votes'.[23] We can say on the basis of experience that facts have borne out Kunzru's hope rather than Sir Ivor's scepticism. The Government of India has, in fact, treated the Finance Commission's recommendations with great respect. Of the various recommendations made by the four Finance Commissions, only two have failed to be accepted. However, in the memoranda placed before Parliament along with the reports of the Finance Commission, the Government of India has always taken care to argue its case fully where it found itself unable to accept a particular recommendation of the Commission. One such case was the second Finance Commission's recommendation in favour of the consolidation of Central loans to the States and revision of interest rates on these loans. All the same, the Government of India did make substantial modifications in interest rates in the light of the Commission's recommendations. In the event, therefore, the object behind the Commission's recommendation was more or less achieved even though the recommendation itself was not formally accepted in the form in which it had been made. The net result of the action taken by the Government was 'to reduce by Rs. 4 crores per annum (as against Rs. 5 crores estimated by the Finance Commission) the interest burden on the States on account of loans taken between August 15, 1947 and March 31, 1958'.[24] Similarly, the Union Government did not accept the majority recommendation of the third Finance Commission to the effect that the States be given grants-in-aid with a view to covering 75 per cent of the revenue component of State Plans. Apparently, the Government was influenced by the strong case made out against the proposal by G. R. Kamat, Member-Secretary of the Commission, in his minute of dissent. It may be pointed out here that despite Kamat's dissent, the Union Government accepted the Commission's majority recommendation in favour of a special earmarked grant to certain States for the improvement of road communication. The Government made slight modifications in some of

[23] Sir Ivor Jennings, *Some Characteristics of the Indian Constitution*, Madras, 1953, pp. 72–73.

[24] Reserve Bank of India, *Report on Currency and Finance for the Year 1957–58*, Bombay, 1958, p. 91.

the recommendations of the fourth Finance Commission but these modifications were in line with the recommendations themselves and were necessitated by the absence of necessary data. The fact is that the Union Government gives close and careful consideration even to the general observations which the Finance Commission may find it necessary to make even if they do not arise out of its prescribed terms of reference.

CHAPTER VI

THE FINANCE COMMISSION AND FEDERAL FINANCIAL RELATIONS

1. THE FINANCE COMMISSION AND TRANSFER OF RESOURCES

THE recommendations of the four Finance Commissions so far constituted have resulted in an increasing quantum of transfer of resources from the Centre to the States both in the form of devolution of tax revenue and in that of statutory grants-in-aid. Thus, as regards income tax, the States' share in the net proceeds has risen from 50 per cent as it stood at the time of the appointment of the first Finance Commission to 75 per cent at present.[1] There has been an even more significant rise in the share of the proceeds of Union excise duties distributed among the States. Until 1952 the States received no share of these duties. The first Finance Commission, accordingly 'broke new ground' by recommending that 40 per cent of the net proceeds of Union excise duties on three commodities (tobacco, matches and vegetable products) should be distributed among the States. The second Finance Commission added five more commodities, *viz.*, sugar, tea, coffee, paper and vegetable non-essential oils to those recommended by the first Finance Commission

[1] In raising the States' share of the divisible pool of general income tax from 60 to 66⅔ per cent, the second Finance Commission was influenced by the fact that the amendment of the Income Tax Act in 1959 had resulted in the exclusion of the tax paid by companies from 'income tax' and the consequent reduction of the divisible pool. In further raising the States' share to 75 per cent, the fourth Finance Commission took into account the representations made by State Governments pressing the need for further abating the loss incurred by them as a result of the reclassification of income tax paid by companies.

It is understandably felt now that the States' share of the income tax pool cannot be raised any further. The Union Government which levies and collects the tax must evidently receive a share substantial enough to be an incentive. *Report of the (Fourth) Finance Commission*, 1965, Minute by Bhabatosh Dutta, paras 9–19, pp. 95–100

but, at the same time, reduced the States' share of the net proceeds of the duty on all the eight commodities to 25 per cent. The third Finance Commission favoured 'the participation by the States, by convention, in the proceeds of all Union excises'.[2] In its actual recommendations, the Commission raised the number of commodities the proceeds of excise duty on which was to be shared with the States to 35 and fixed 20 per cent of the net proceeds as the share of the States. The Union excise duty on motor spirit was excluded from this computation, but the Commission recommmended that a sum of Rs. 9 crores, being approximately 20 per cent of the annual yield of this duty, should be utilized in each of the four years (1962-65) covered by its report as a special purpose grant to certain States for the improvement of communications.[3] The fourth Finance Commission included the proceeds of all Central excise duties including those that might be levied during the five years covered by its recommendations, in the divisible pool of excise duties.[4] This, as one writer has put it, 'will enable the States to share a source of revenue which has so far been a very buoyant one'.[5]

As the result of an agreement between the Union Government and State Governments (embodied in a decision of the National Development Council in 1956), the Government of India decided, in 1957, to levy an additional excise duty on mill-made textiles, sugar and tobacco (and, later, silk fabrics) to replace the sales tax levied by the States and to distribute the net proceeds among the States subject to the condition that the income derived by each State from its sales

[2] The Commission observed : 'We consider that 20 per cent of the net proceeds of Union duties of excise on all commodities on which such duties are collected, would be appropriate for the purpose we have in view.' *Report*, 1961, para 44, p. 21.

[3] *Ibid*.

[4] *Report of the (Fourth) Finance Commission*, 1965, para 59, p. 29. The Commission emphasised the importance of imparting greater certainty to the distribution among the States of their share of divisible taxes and was critical of the tendency of successive Commissions to make changes in the principles governing the distribution. In a separate note, the Chairman suggested that 'a definite allocation by way of percentages of shares of the Union and States respectively may be fixed by the Constitution itself. *Ibid*., para 19(2), p. 92.

[5] P. C. Mathur, 'The Fourth Finance Commission', *The Indian Journal of Public Administration*', Vol. XI, No. 4, p. 759.

tax on these articles should be guaranteed to it.[6] The second Finance Commission determined the income of each State from these duties in 1956–57 and, after providing for this 'guaranteed' amount (Rs. 32.5 for all States as a whole), divided the balance of the proceeds among the States.[7] The third Finance Commission, after providing for the 'guaranteed' amounts, distributed the balance among the States partly on the basis of the percentage increase in the allocation of the sales tax in each State since 1957–58 (the year in which additional excise duties were first levied) and partly on the basis of population.[8] Making a departure from this basis, the fourth Finance Commission recommended that after the payment of 'guaranteed' amounts, the balance should be distributed among the States on the basis of the proportion of the sales tax revenue realized in each State to the total sales tax collected in all the States taken together over the years 1961–62 to 1963–64. The Commission took the view that 'figures for collection of all sales taxes in a State are a more direct indication of the contribution made by each State to the divisible surplus than population'.[9]

The recommendations of the successive Finance Commissions have also resulted in a progressive increase in the amount of Union grants-in-aid of the revenues of the States under Article 275(1) of the Constitution. Before 1952, grants analogous to those given by the Centre to the provinces constituted an insignificant part of Central assistance received by the provinces. The first Finance Commission recommended the payment of a little over Rs. 5 crores per year as grants-in-aid of the revenues of the States. As a result of the recommendations of the second Finance Commission the amount rose to Rs. 37 crores a year. The third Finance Commission further raised the amount to over Rs. 52 crores a year. While the third Finance Commission recommended grants for all the States, the fourth Finance Commission recommended them for 10 states, the six States excluded being Bihar, Gujarat, Maharashtra, Punjab, Uttar Pradesh and West Bengal. The quantum of grants to the beneficiary States

[6] Apparently, the object of the change was to bring about uniformity in the levy on items of such large consumption and minimize chances of evasion.

[7] *Report of the (Second) Finance Commission*, 1957, para 172, p. 61.

[8] *Report of the (Third) Finance Commission*, 1961, para 56, p. 27.

[9] *Report of the (Fourth) Finance Commission*, 1965, para 71, p. 34.

was, however, raised to approximately Rs. 120 crores a year.[10]

To sum up : 'shared taxes and grants were Rs. 52.9 crores and 33.9 crores respectively in 1951–52. Since then they have steadily risen to Rs. 276 crores and Rs. 350.5 crores by 1965–66 (R.E)…. The recommendations of the fourth Finance Commission regarding devolution of resources on the States during the fourth plan period have substantially benefited the States with respect to shared taxes and grants. Thus while in 1965–66 (R.E.) the States received Rs. 276 crores as shared taxes and Rs. 351 crores as grants, in the budget estimates for 1966–67 these have risen to Rs. 361 crores and Rs. 400 crores respectively'.[11]

2. THE FINANCE COMMISSION AND STATE AUTONOMY

The above summary of the principal recommendations of the four Finance Commissions brings out clearly the considerable impact they have had on Union-State financial relations. The Commission has been responsible for a steadily increasing quantum of resources transferred from the Centre to the States by way of shared taxes and grants under Article 275(1) of the Constitution. In recommending these transfers, the successive Finance Commissions have been guided by a number of considerations. These are[12] :

> First, the transfer of resources from the Centre must be such as it can bear without undue strain on its resources, taking into account its responsibility for such vital matters as the defence of the country and the stability of its economy ; second, the increasing needs of the States, particularly on account of the increasing expenditure on developmental functions, must be provided for ; third, the transfer of resources from the Centre should be so effected that while the needs of the States are met, they can, at the same time, perform their functions with the maximum autonomy and without a reduction in their own

[10] The Fourth Finance Commission recommended larger grants to the States than the Third Finance Commission as the relative financial weakness of the States was not taken as a factor in determining their share of excise duties as had been done by the Third Finance Commission.

[11] *Reserve Bank of India Bulletin*, May 1966, p. 473. The figures for grants include plan grants as well as grants made on the recommendation of the Finance Commission.

[12] P. C. Mathur, *op. cit.*, p. 751.

sense of responsibility, both, in the raising and the distribution of their expenditure ; and fourth, it should attempt to reduce inequalities between the States.

From the point of view of federal relations some of these points deserve a somewhat extended examination. The observation 'the present Finance Commission have shown themselves more keenly aware of the problems of State finances as a whole and have been more considerate towards their needs than anybody entrusted with similar tasks in the past'[13] was made in reference to the second Finance Commission but is applicable equally to all the four Commissions. Central assistance to the constituent units has come to be a regular feature of all federal States. In other federations, this assistance is largely of a discretionary character and has led to considerable Central encroachments on the autonomy of the units. The important thing about the devolution of funds to the States in India on the basis of the recommendations of the Finance Commission is that this devolution is of a statutory character and does not involve Central control over its utilisation. In fact, the funds transferred to the States on this basis are, for all practical purposes, a part of their respective Consolidated Funds. Accordingly, there is no erosion of the autonomy of States. Central grants to the States under Article 275(1) are, by and large, untied[14] and unconditional. There is no requirement of matching contributions and the recipient States are free to utilize them for any purpose they deem necessary. On the contrary, plan grants under Article 282 are conditional and have various 'strings' attached to them. They are ear-marked for specified purposes. The Central authorities concerned reserve the power to examine and approve the schemes in respect whereof these grants

[13] Reserve Bank of India, *Report on Currency and Finance for the year 1957–58*, Bombay, 1958, p. 81. Noting the 'understandable interest in the expansion of the States' resources' displayed by the successive Finance Commissions, A. Krishnaswami has observed : 'Thus the Finance Commissions, by widening the ambit of shared revenues and recommending transfers on an unconditional basis to the States, have attempted to make them more solvent and self-reliant.' *The Indian Union and the States*, London, 1965, p. 45.

[14] The only instances of special purpose grants recommended by the Finance Commission are the grants for expanding primary education and for improving communications recommended respectively by the first and the third Finance Commissions.

are offered and to supervise their proper utilisation. Above all, they can be used as an instrument for influencing the fiscal policy of the States to suit national purposes through the device of matching grants. Evidently, therefore, the Finance Commission has become a vital part of the machinery of the Indian federal system and its recommendations have had the result of strengthening the finances of the States without making them vulnerable to Central control. True, the Finance Commission can offer the States only partial protection against Central inroads on their autonomy. As we have noted in Chapter IV, by far the larger part of Central assistance to the States flows through grants under Article 282 of the Constitution and through loans. The so-called 'plan' grants, which the States cannot refuse unless they are prepared to forego the benefits of development, open the door to Central control.[15]

While the Finance Commission's basic approach has been that 'the prosperity of the States must rest on the solid foundation of a reasonably strong and financially stable Centre'[16], it has shown a keen awareness of the growing needs of the States 'in fulfilling a complementary role in the development of national economy and in the provision of a higher level of social services'.[17] The Commission has also recognised the inadequacy of resources of the States and their growing dependence on the Centre. The successive Finance Commissions have, no doubt, pointed out that the financial weakness of the States is due, partly at least, to 'inadequate expenditure control' and 'inadequate mobilisation of available resources'. They have particularly noted that the States 'are tending to develop an allergy to tap resources in the rural sector'.[18] Nevertheless, the Finance Commission has expressed the view that the inadequacy of the States' resources 'is attributable mainly to the planning process and that it may become more pronounced with the completion of

[15] In his minute, P. V. Rajamannar, Chairman of the Fourth Finance Commission has, like many others, declared: 'In my opinion article 282 was never intended for the purpose for which it is now being used.' Para 15, p. 91.

[16] K. Santhanam, *Union State Relations in India*, Bombay, 1960, pp. 40–41.

[17] *Report of the (Third) Finance Commission*, 1961, para 40, p. 20.

[18] *Ibid.*, para 89, p. 38.

each successive Plan for some years to come'.[19] Further, the Commission has recognised the fact that Central assistance to the States through plan grants under Article 282 of the Constitution is bound to affect State autonomy. Taking note of the complaint made by the States against a 'perceptible trend of centralisation of resources in addition to centralisation of certain State function',[20] the third Finance Commission observed: 'While we appreciate that in a planned economy a measure of centralisation and even regimentation is inevitable, it is no less necessary that the States should not feel that their autonomy is being frustrated'.[21]

It is in the background of this concern for State autonomy that the implied criticism of the dual system of grants to the States (the general-purpose grants made under Article 275(1) of the Constitution and routed through the Finance Commission and specific and conditional plan grants under Article 282 without reference to it) in the report of the third Finance Commission becomes important. It is in regard to the discretionary grants under Article 282 that complaints of centralization are most frequently made. These grants, in fact, account for a substantial part of the total Central assistance to the States and have come to overshadow the transfers made on the recommendations of the Finance Commission. The third Finance Commission drew attention to the fact that though assistance under Article 282 formed 48.7 per cent of the total in the year 1952–53, it had assumed the proportions of 80.2 per cent in the budget for 1961–62.[22] Evidently, it is with a view to safeguarding the autonomy of the States by reducing and limiting the part played by discretionary plan grants in the growth of centralization that the Third Finance Commission recommended that 'the total amount of grants-in-aid should be of an order which would enable the States, with any surplus out of the devolution, to cover 75 per cent of the revenue component of their Plans'.[23] The same concern for State autonomy

[19] *Ibid.*, para 44, p. 21.

[20] *Ibid.*, para 84, p. 38.

[21] *Ibid.*, para 66, p. 30.

[22] *Ibid.*, para 96, p. 40.

[23] *Ibid.*, para 77, pp. 31–32. This was a majority recommendation of the Commission. In his minute of dissent, Member-Secretary G. R. Kamat argued strongly in favour of the maintenance of the existing system under

is reflected in the Commission's attempt to draw attention to 'the mounting interest liability which is devolving on the States both on loans raised by themselves and loans granted to them by the Union Government'[24] and the question raised by it whether it would not be advisable to have a period of moratorium on interest followed by a period of weighted rate of interest to compensate the Union Government for the interest foregone over the period of moratorium.[25] Analysing the budgetary implications of borrowings by State Governments, the Fourth Finance Commission suggested that 'a survey of the present system of inter-governmental borrowing is necessary as much in the interests of the States as that of the Government of India'.[26] The Finance Commission's concern over the growing dependence of States on the Union Government and the consequent danger to their autonomy may be seen, further, in the third Commission's suggestion regarding the appointment of 'an independent Commission' to undertake a comprehensive examination to assess the tax potential of each State, to review its tax structure and to recommend rates under different heads of levies in the State List'. The proposed Commission would also consider 'what adjustments, if any, should be made in Union-State financial relations which would add strength to both the Union and the States'.[27] In his separate note to the report of the Fourth Finance Commission, Chairman P. V. Rajamannar expressed himself explicitly in favour of the appointment of a special Commission to review the Union-State financial relations.[28] In view of all this evidence, there is no

which plan grants are made 'on an yearly appraisal of the requirements of the States and the Centre's ability to meet these requirements. The point that the existing procedure ensures the necessary uniformity and coordination has also been made by other observers. See, for example, P. C. Mathur, *op. cit.*, p. 764, and K. V. S. Sastri, *Federal State Fiscal Relations in India*, Bombay, 1966, pp. 18–21. Asok Chanda, however, feels that by leaving 25 per cent of the fiscal needs uncovered to be met by the Planning Commission, the Finance Commission 'had provided a safeguard which could be used to bring a recalcitrant state to heel.' *Federalism in India*, London 1965, p. 222.

[24] *Ibid.*, para 100, p. 41.

[25] *Ibid.*, para 101, p. 42.

[26] *Report of the (Fourth) Finance Commission*, 1965, para 146, p. 65.

[27] *Report of the (Third) Finance Commission*, 1961, para 93, p. 39.

[28] *Report of the (Fourth) Finance Commission*, 1965, Minute by P. V. Rajamannar, para 19, p. 92.

justification for the view that the 'Union Government, under the influence of the Finance Commission, exercises a dominant role over the finances of the State Governments and thus, perhaps, reduces the autonomy of the States to a large extent'.[29] The Union Government does exercise a sort of financial paramountcy over the States but this is by no means done 'under the influence of the Finance Commission'. On the contrary, the Finance Commission's role has been to strengthen the finances of the States without prejudice to State autonomy.

Another aspect of the Finance Commission's work relates to the problem of inter-State disparity. The problem arises from the conflict between the objectives of growth and equalization. From the national point of view, the principal aim of planned development is to raise the rate of growth of income to the maximum extent feasible on the basis of available resources. From the regional point of view, the mitigation of inter-State inequalities is an equally desirable objective. While the problem exists in every federation, the degree of the conflict between the objectives of growth and equalization varies with the degree of emotional and cultural integration achieved in a particular federation. Accordingly, 'a purely growth-oriented system of federal fiscal transfers will not be practicable in any federation and more especially in a federation characterised by strong fissiparous tendencies'.[30] It is, of course, impossible to achieve a perfect redistribution of incomes among the component units of a federation. What is usually attempted is to ensure a minimum standard of administration and social services in all the units, and this is generally sought to be achieved through grants and federal tax expenditure.

The Finance Commission in India has rather limited powers of helping to achieve equalization among the States. Even so, it has occasionally been criticised for neglecting the poorer States. The criticism is rather unfair since the mitigation of inter-State disparities has, in fact, been one of the important considerations which the successive Finance Commissions have kept before them. In assessing the needs of different States and in determining how the States,

[29] B. R. Misra, *Economic Aspects of the Indian Constitution*, Calcutta, 1958, p. 93.

[30] K. V. S. Sastri, *op. cit.*, p. 9.

individually, should share the quantum of Central assistance, the Commission has been guided, *inter alia*, by the principle that 'the scheme of distribution should attempt to lessen the inequalities between the States'.[31] Keeping before itself the ideal of maximum national welfare, the Commission has, to some extent, geared its proposals to the need of 'equalizing standards of social services' in different States. Obviously, this means that Central assistance should be relatively greater in the case of backward States since 'a principle of proportionate allocations will merely perpetuate underdevelopment in these States'.[32] Thus, the first Finance Commission observed : 'grants-in-aid may be given to help a State to meet special burdens and obligations of national concern, although within the State sphere, if they involve an undue burden on its finances'.[33] This principle has also, in some measure, been followed by the Finance Commission in regard to the devolution of tax revenue.

When the proceeds of income tax were made divisible under the Government of India Act, 1935, the Nieymier Award allocated 50 per cent of the net proceeds for distribution among the provinces. As regards allocations from the divisible pool to different provinces, the principle adopted was that of achieving 'financial equilibrium' and of ending the 'chronic state of deficit in some provinces'.[34] However, in the actual scheme of distribution recommended in the Award, population and collection were given roughly equal weight resulting in a greater differential advantage to the industrially advanced provinces like Bombay and Bengal. Thus, the Award ignored the greater fiscal needs of backward provinces and tended to accentuate rather than reduce the disparity of resources.

The first Finance Commission made a radical departure from the precedent set by the Nieymier Award, not only by raising the quantum of the States' share of the net proceeds of income tax from 50 to 55 per cent but (in determining the share of each State separa-

[31] *Report of the (First) Finance Commission*, 1952, p. 8.

[32] The principle of giving special grants to poorer States was emphasised by the Expert Committee on the Financial Provisions of the Constitution appointed by the Constituent Assembly. However, the problem was left to be dealt with by the Finance Commission.

[33] *Report of the (First) Finance Commission*, 1952, p. 97.

[34] *Indian Finance Enquiry Report* (by Sir Otto Nieymier), 1936, p. 4.

tely) by giving a much greater importance to the factor of population, (80 per cent as against 20 per cent for collection) as a 'broad measure of need'.[35] The change was evidently made with a view to reducing the disparity in the resources of the States. The second Finance Commission raised the States' share of the divisible pool of income tax from 55 to 60 per cent. It also expressed itself in favour of completely discarding collection as a factor in computing the shares of different States. However, to avoid a sudden break in continuity, it recommended that the distribution of the States' share should be 10 per cent on the basis of collection and 90 per cent on that of population. This, the Commission felt, 'should make it easy to complete, in due course, the process of eliminating the factor of collection altogether and distributing the entire amount of the States' share on the basis of population'.[36] This was undoubtedly an important step in the direction towards reducing the disequilibrium of resources among the States. The third Finance Commission recommended a reversion to the relative weightage given by the first Commission to population and collection. In doing so, it was influenced by the fact that the income tax paid by companies had been excluded from the divisible pool and the consideration that the States with larger collections had special problems relating to the maintenance of law and order and the administration of social services.[37] However, it was quite as emphatic as the two earlier Commissions in stressing the need for correcting the disequilibrium and lack of balance between financial capacity and financial need which characterises different States in the Indian Union.

The Finance Commission has followed a similar approach in regard to the devolution of other tax revenues. Thus, the Third Finance Commission declared :[38]

[35] *Report of the (First) Finance Commission*, 1952, p. 105.

[36] *Report of the (Second) Finance Commission*, 1957, para 105, p. 40.

[37] *Report of the (Third) Finance Commission*, 1961, para 35, p. 18. The Fourth Finance Commission rejected claims based on area, backwardness, financial weakness and proportion of Scheduled Castes and Tribes in the population, but it did help the weaker States by maintaining the ratio between population and collection as recommended by the First and Third Commission.

[38] *Report of the (Third) Finance Commission*, 1961, para 47, p. 22.

> We consider that while population should continue to be the major factor for distribution, the relative financial weakness of the States, the disparities in the levels of development reached, the percentage of scheduled castes and tribes and backward classes in their population etc., should be taken into account in determining the share allocation to each State individually.

Further, it is in an attempt to lessen inequalities among the States that the first Finance Commission recommended a special purpose grant to some States for expanding primary education and the third Finance Commission recommended a similar grant for the improvement of communications. In both cases, the grants were recommended under Article 275(1) of the Constitution. While the principle of 'levelling up' has been generally welcomed, there has been some criticism that the actual recommendations of the Finance Commission have fallen far below the ideal proclaimed and that 'they should have kept before them the necessity for substantial assistance to the backward States to enable them to raise their standards of all the services'.[39] The Commission, it is contended, has failed to use the balancing factor incorporated in the Constitution to the maximum advantage.

3. THE FINANCE COMMISSION AND THE PLANNING COMMISSION

The above analysis of the working and role of the Finance Commission shows that the Commission has regarded as one of its functions to 'safeguard the position of the States' and to counteract the tendency of Central assistance to the States to be discretionary in character and 'not based on the principle of uniform application'.[40] But the Finance Commission's role has been considerably restricted by the activities of the Planning Commission. As D. R. Gadgil has observed, 'planning has put a significant part of the financial arrangements between the Union and the States out of the purview of the Finance Commission'.[41] The Third Finance Commission declared that 'the role and functions of the Finance Commission, as provided in the Constitution, can no longer be realized fully due to the emer-

[39] R. N. Bhargava, *The Theory and Practice of Union Finance In India*, London 1956, p. 122.

[40] *Report of the (Third) Finance Commission*, 1961, para 79, p. 35.

[41] D. R. Gadgil, *Planning and Economic Policy*, Bombay 1965, p. 295.

gence of the Planning Commission as an apparatus for national planning'.[42]

The Finance Commission has had a feeling of uneasiness regarding its relationship with the Planning Commission. The issue of this relationship was first raised by the second Finance Commission and has received a great deal of attention at the hands of the two subsequent Finance Commissions. The problem is mainly one of 'duality and overlap'. The functions of the two Commissions have not been made absolutely distinct. A part of the problem of co-existence between the two Commissions was solved by restricting the recommendations of the fourth Finance Commission to a period of four years. The idea was that the period covered by subsequent Finance Commissions should be that of a Five-Year Plan. However, other problems still remain. It is the Planning Commission that determines the size of the Plan, lays down priorities, decides the quantum of resources to be raised by the Centre and the States and the assistance to be given by the Centre to the States. When the Finance Commission begins its work, it is required to keep in view the requirements of the Plan. The result, evidently, is that it has to function within the lines already drawn by the Planning Commission. In view of this, the third Finance Commission declared :[43]

> The role of the Finance Commission comes to be, at best, that of an agency to review the forecasts of revenue and expenditure submitted by the States and the acceptance of the revenue element of the Plan as indicated by the Planning Commission for determining the quantum of devolution and grants-in-aid to be made ; and, at worst, its function is merely to undertake an arithmetical exercise of devolution based on amounts of assistance for each State already settled by the Planning Commission, to be made under different heads on the basis of certain principles to be prescribed.

It would, of course, be a gross exaggeration to hold that the Finance Commission has become 'a servant of the Planning Commission'. It is nevertheless necessary to point out that the situation is rather anomalous and that there is obvious need for a better defini-

[42] *Report of the (Third) Finance Commission*, 1961, para 79, p. 35.
[43] *Ibid.*, para 80, p. 35.

tion of the respective roles of the two Commissions and for greater co-ordination of their activities. The third Finance Commission's view that either the Finance Commission's scope should be considerably widened or that the Planning Commission should itself be transformed into a Fianance Commission at the appropriate time brought the problem into clear focus.[44]

The Fourth Finance Commission also took note of the overlap of functions and the diminution of the area of the Finance Commission's effectiveness as a result of the activities of the Planning Commission. In his separate minute to the Commission's report, P. V. Rajamannar gave a good deal of attention to this matter. He pointed out correctly that 'when compared to a statutory body like the Finance Government, which is quite independent of the Government, the Planning Commission may be described as a quasi-political body'.[45] He also underlined the fact that it is not easy to describe the Planning Commission's status *vis-a-vis* the Government and that 'it remains to this day a body without any constitutional or legislative sanction'.[46] Drawing attention to the need for clarifying and defining the scope and purpose of grants under Articles 275 and 282, he suggested that 'the Planning Commission may be given the status of an independent, permanent statutory body'.[47]

[44] *Ibid.*, para 81–82, pp. 35–36.

[45] *Report of the (Fourth) Finance Commission*, 1965, Minute by P. V. Rajamannar, para 12, p. 90.

[46] *Ibid.*

[47] *Ibid.*, para 19(1), p. 92.

CHAPTER VII

CONCLUSION

CERTAIN broad conclusions have emerged from our analysis of the working of Union-State financial relations in India. These conclusions have been indicated at various stages in our study and may now be brought together here. In the first place, while the financial balance of power established by the Constitution guaranteed enough autonomy to the States to make ours a genuinely federal system, it left the States in a position of relative financial inadequacy. It was with a view to removing this inadequacy without compromising State autonomy that the Constitution provided for various modes of financial adjustment between the Union and the States (such as tax sharing and Union grants in aid of the revenues of States under Article 275) and established an independent agency, the Finance Commission, for working out these adjustments. The constitution-makers evidently felt that these arrangements would place enough funds at the disposal of State Governments to enable them to meet their constitutional obligations in respect of social services and welfare activities. They felt—and not without justification—that, in terms of financial powers, they were placing the States in India in a better position than is the case with the component units of most of the older federations.

Our second conclusion has been that the hopes of the framers have not been realised. This has been due mainly to the advent of centralised planning. National planning has resulted in the growing dependence of the States on Central assistance in the form of grants and loans. Considering that far greater use has been made of discretionary and conditional grants under Article 282 of the Constitution than of statutory, and mainly unconditional, grants under Article 275, the increasing injection of Central aid has come to pose a serious danger to State autonomy. This development has aggravated the original imbalance between Union and State resources and is understandably causing much concern to all those interested in the smooth working of our federal polity.

We have seen, in the third place, that planning does not offer a complete explanation of the financial straits in which most States find themselves. Part of the blame rests squarely on their own shoulders. By and large, States have failed to show enough vigour or enthusiasm to develop and mobilise their own tax resources. Their failure to tap the tax potential of the countryside has been the subject of frequent adverse comment. At the same time, most States are prone to improvidence and lack of financial discipline. State overdrafts on the Reserve Bank of India have provoked occasional admonitory gestures from the Centre but, time and again, the latter has 'merely put through bailing operations in the form of *ad hoc* loans to enable the States to pay off their dues to the Reserve Bank.'[1] Proposals to deal with this situation have been under discussion for quite some time, but suitable mechanics for controlling this unhealthy practice have yet to be devised. As it is, the States have been too prone to importunate the Planning Commission and Union Government for ever larger subventions and to rely unduly on the Finance Commission for recommending larger and larger transfers of funds from the Centre.

In the fourth place, despite the commendable concern it has shown for safeguarding the financial stability and autonomy of the States, the Finance Commission has not been able to play its constitutional role as effectively as it might have. In fact, it has been somewhat overshadowed by the non-statutory but far more powerful Planning Commission. The simultaneous existence of these two bodies, both covering a great deal of common ground, has created an anomalous situation to which successive Finance Commissions have drawn attention. The problem of the co-existence of the two Commissions remains to be resolved. Referring to the overlap of functions as between the two Commissions, the third Finance Commission proposed the acceptance of one of the two alternatives ; 'the first is to enlarge the functions of Finance Commission to embrace total financial assistance to be afforded to the States, whether by way of loans or devolution of revenues, to enable them both to balance their normal budgets and to fulfil the prescribed targets of the Plan....The second is to transform the Planning Commis-

[1] *The Hindustan Times* (*Editorial*), 24 February 1968, p. 7.

sion into Finance Commission at the appropriate time.'[2] The idea of enlarging the scope of the Finance Commission was opposed by the Member-Secretary, G. R. Kamat, and was not implemented by the Union Government. The Chairman of the fourth Finance Commission, in a separate minute, stated frankly that 'it is the setting up of the Planning Commission that has in practice restricted the scope and functions of the Finance Commission'.[3] He declared, further :

> The legal position is that there is nothing in the Constitution to prevent the Finance Commission to take into consideration both Capital and Revenue requirements of States in formulating a scheme of devolution and in recommending grants under Article 275 of the Constitution. But, the setting up of the Planning Commission inevitably has led to a duplication and overlapping of functions to avoid which, a practice has grown up, which has resulted in the curtailment of the functions of the Finance Commission.

This is not the place to go into the question how the problem of the co-existence of these two important agencies should be settled. It is enough to say that the problem demands an urgent solution. As one expert has observed : 'While the limited importance of the transfers governed by the Finance Commission constitute a serious limitation, it would by no means constitute a fatal defect if either one of the two following conditions were fulfilled : (*a*) The Finance Commission and the Planning Commission both worked together for a common goal in their own spheres with the same tests in a spirit of non-grudging co-operation or (*b*) The functions were made absolutely so distinct that each could operate its own criteria within its demarcated boundary without impinging on the utility of the other.'[4] It is problematic whether the situation can be improved by making the Finance Commission a permanent body with terms of reference covering all federal fiscal transfers including loan transactions. It cannot be denied, however, that there is need to make the Finance Commission more effective. One little

[2] *Report of the (third) Finance Commission*, 1965, paras 82–83, pp. 35–36.

[3] *Report of the (fourth) Finance Commission*, 1965, Minute by Dr. P. V. Rajamannar, para 8, p. 88.

[4] *Ibid.*, para 9, p. 89.

suggestion which the second and third Finance Commissions made and which the fourth Finance Commission has reiterated can be easily implemented. This relates to 'the need for collecting reliable statistical data on a continuous basis and making them available to the Finance Commissions at the very commencement of their work'.[5] This suggestion can be implemented by the establishment of a permanent unit in the Union Ministry of Finance manned by suitably qualified experts.

Finally, for some time past the need for a careful and objective review of Union-State financial relations has been stressed by a number of individuals and organisations. This review has evidently become necessary as the seventeen years during which our Constitution has been worked have revealed the growing weakness of the States *vis-a-vis* the Centre. The Finance Commission, which was provided for in the Constitution with a view to filling the States' revenue gap without eroding their autonomy, has failed to play the role envisaged for it on account of the emergence of the Planning Commission.

As far back as 1962, T. T. Krishanamachari, the then Union Minister without Portfolio, suggested 'a re-examination of the relationship between the Centre and the States and their respective spheres of power'.[6] Referring more specifically to Union-State financial relations, the Chairman of the fourth Finance Commission observed[7] :

> After fifteen years of the working of the provisions of the Constitution, during which period four Finance Commissions have been appointed, I think the time is ripe to have a review of the Union-State financial relationship, particularly in view of the

[5] D. T. Lakdawala, 'The Four Finance Commissions in India', *The Indian Economic Journal*, Vol. XIII, No. 4, 1966, p. 504.

[6] *The Hindustan Times*, 10 September 1962, p. 5.

[7] *Report of the (Fourth) Finance Commission, 1965*, Minute by Dr. P. V. Rajamannar, para 19, p. 92. Another member of the Commission asserted : "It is, however, difficult to ignore the fact the fifteen years that have elapsed since the adoption of the Constitution have seen very large changes in the economic and financial background on which the original provisions regarding the Union-State financial relations were based. It is time now to re-examine the whole scheme of devolution without excluding from the purview of such re-examination the possible need for changes in the constitution." Minute by Prof. Bhabatosh Datta, para 6, p. 95.

setting up of the Planning Commission. This review should be made by a special Commission who can approach the several problems that have arisen in the past and that are likely to arise in the future objectively and realistically.

The demand for a review and rearrangement of Union-State financial relations is likely to acquire a sharper edge as a result of non-Congress governments having come to power in some of the States. C. M. Annadurai, leader of the DMK, has declared that his party 'would demand more powers to the States in the fields of education, taxation, industry and planning'.[8]

[8] *The Hindustan Times*, 26 February 1967, p. 4.

POSTSCRIPT

THIS monograph was written and part of it also went through the press before the fourth general election wrought a radical transformation in the political landscape of India. The one-dominant-party situation was swept off the board and in some of the States—nine, at one time—non-Congress governments assumed the reins of power. Inevitably, the new power spectrum was bound to have a profound effect on the working of federal relations in the country. The constitutional pattern of Union-State relations has remained unchanged, but the political context within which they operate has been totally transformed.

Complaints of the Centre's domination over the States were heard even when the Congress controlled not only the government at the Centre but also those in the States. It was only to be expected that non-Congress State governments, some of which were and remain vociferously hostile to the Congress-controlled Centre, would demand a review of Union-State relations as provided for in the Constitution and, in particular, of the manner in which they worked in practice. The demand for a redefinition of federal financial relations and a redistribution of sources of revenue such as to widen the ambit of State autonomy was specifically made.

The first to call for such a redefinition was C. Annadurai, Chief Minister of Madras. Predictably, the Kerala Chief Minister, E. M. S. Namboodiripad, has been pressing the demand with greater persistence. Recently he has asked for the setting up of a new Constituent Assembly to draft a new Constitution reflecting present realities. The demand was picked up by jurists, journalists, politicians and academics and the issue has been discussed in numerous forums. At a seminar organised by the Bar Association of India at New Delhi in March 1967, former Chief Justice of India, K. Subba Rao, and former Attorney General, M. C. Setalvad, laid stress on the Constitution's 'very clear and unmistakable bias towards the Centre'. Referring to the new political situations emerging after the fourth general election, Subba Rao observed: 'With different parties in different States, hereafter the emphasis must be more on cooperation

than on control, more on patriotism than on authoritarianism, more on healthy competition than on regimentation.........more on objective appreciation of the States' problems than on partisan approach.' Setalvad was happy that 'the stranglehold of Delhi' over the States had ceased. Justice M. Hidayatullah of the Supreme Court expressed the consensus of the seminar when he declared that the Constitution would be put to severe strain unless the States were allowed a 'freer' hand in legislation, administration and finance. This States' right sentiment is not an entirely new development in India but it has come very much to the fore since the last election.

Some sixteen months have passed since the election took place. It is, therefore, possible to view recent developments in perspective and to map out, with some measure of certainty, the likely course of federal relations in India in the years to come. Naturally we are concerned here mainly with federal relations in the sphere of finance. In the first place, despite the noise that has been made of late about the need for a review and revision of Union-State relations in India, it remains indisputable that the Constitution has laid down a reasonably satisfactory balance of financial power between the Union and the States. The evident financial dependence of the States on the Union has resulted largely from eventualities not visualised in the Constitution. It is true that most of the elastic sources of revenue, *e.g.*, income tax and excise duties, have been enumerated in the Union List. It must, however, be recalled that the proceeds of these sources of revenue do not belong exclusively to the Union government. The former *must* and the latter *may* be (and, in fact, are) shared with the States. We have seen in the preceding chapters that, as a result of the recommendations of successive Finance Commissions, the States' share of these resources has been steadily increasing. This has imparted an appreciable measure of elasticity to the States' revenues. Central manipulation of Plan grants under Article 282 has, no doubt, tended to distort the constitutional pattern of Union-State financial relations thereby causing considerable erosion of the autonomy and initiative of State governments. Here, again, as we have had occasion to point out, the uses to which Article 282 has been put were not anticipated by the constitution-makers. By and large, one would say, the financial dependence of the States on the

Centre has been the outcome of their failure—a failure attributable to political rather than fiscal reasons—to develop their own resources on the one hand, and their tendency to flout the canons of financial discipline on the other. Witness the haste with which State governments, Congress and non-Congress alike, have either abolished or abated the incidence of land revenue to win rural support and have scaled up the dearness allowance of their employees to the Central level. Overdrafts from the Reserve Bank of India have, to a large extent, been checked, but State governments continue to budget for deficits from year to year hopefully looking to the Finance Commission to fill the gaps. It would, therefore, seem that there is far less need for a revision of the financial equation laid down in the Constitution than for the States to learn to stand on their feet and to cut their coats according to their cloth. At the same time, no doubt, it is necessary to plug loopholes like the one available in Article 282 through which the Central government doles out a great variety of discretionary grants in order to impose on the States' development priorities which are determined by Central authorities but which may not be welcome to the States or even in accord with their genuine needs.

In two directions desirable changes have already taken place or are likely to follow in due course. One such change is the recent reorganisation of the Planning Commission. This body, brought into existence by an executive resolution of the Union Government was originally intended to have a limited role. The Cabinet Secretariat's resolution of March 15, 1950 laid down that 'the Planning Commission will make recommendations to the Cabinet. In framing its recommendations, the Commission will act in close understanding and consultations with the Ministries of the Central Government and the Governments of the States. The responsibility for taking and implementing decisions will rest with the Central and State Governments." This is not how the Commission actually functioned. Over the years it grew into a new Leviathan. What was meant to be an expert advisory body or an arm of the Union Cabinet became, in fact, something of a 'super Cabinet'. The Planning Commission began not only to 'make' but to 'implement' decisions without accepting any responsibility. In the event it turned out to be neither an advisory body nor an implementing authority

in the true sense of the terms. It fell between two stools. As Dr. Vikram Sarabhai, Chairman of the Atomic Energy Commission, graphically put it, 'the wearing of two hats, namely of preparing studies and taking decisions by the same group of persons results in biased studies and warped decision-making'. The Commission's organisation proliferated in a manner which astounded even its most enthusiatic supporters. Thus, in 1967 the strength of its sanctioned staff was 1816, including 446 gazetted officers and its budget estimates exceeded Rs. 1.5 crores with the Prime Minister as its Chairman and several Union Ministers as its members, the Commission became a quasi-political institution and the manner of its working resulted in a blurring of responsibility with every one concerned passing the buck. When things went wrong, the Planning Commission blamed the Union Ministries, the Union Ministries found fault with the Planning Commission, both condemned the States and the States returned the compliment.

The manner of the Planning Commission's growth and working aroused serious misgivings in several quarters. When it was barely seven years old, the Estimates Committee of the Lok Sabha expressed serious dissatisfaction over the Commission's functioning and called for a re-examination of its functions and the dissociation from it of Union Ministers. The Committee asked whether such functions as the annual and periodical allotment of funds should not properly be left to the Government itself 'leaving the Planning Commission to concentrate on the evaluation of the current Plan and the formulation of future Plans'. More recently, the Administrative Reforms Commission has, in its report on the machinery of Planning, suggested the reorganisation of the Planning Commission as a non-statutory advisory body of experts free from all functions of an executive character. It further recommended that the Prime Minister should cease to be chairman of the Planning Commission and that no Central Minister should be its member. While the Union Government has not accepted the recommendation regarding the discontinuance of the Prime Minister as chairman of the Planning Commission, most of the other suggestions of the Administrative Reforms Commission have been accepted and implemented. As far as the Planning Commission's role is concerned, its functions are now to be limited to the formulation of the long-term perspective plan, the

five-year and annual plans and evaluation of plan performance. The reorganised Planning Commission with Dr. D. R. Gadgil as Deputy Chairman has adjusted itself to its new somewhat limited but nevertheless pivotal role.

The Planning Commission has thus been largely depoliticalised. It has been reconstituted into an advisory body of technocrats relieved of the burden of executive functions. This is a matter of great significance for the Finance Commission which should now be in a position to play more effectively than hitherto the role of a balancing wheel of Union-State financial relations envisaged for it by the Constitution. In the past, the Finance Commission has been handicapped not only because of the overlap of functions between it and the Planning Commission but also by the frequent and liberal use made by the latter of discretionary Plan grants under Article 282.

The recently appointed fifth Finance Commission has been given wider terms of reference than any of its predecessors and will be able to make a comprehensive survey of federal financial relations in India. There is need for futher strengthening the position of the Finance Commission with a view to ensuring smooth financial relations between the Union and the States. For instance, the time has come to consider the question of bringing Central assistance to the States under Article 282 or, at any rate, the bulk of this assistance under the purview of the Finance Commission. It may be recalled that the third Finance Commission recommended that the function of future Finance Commissions should be enlarged to embrace total financial assistance to be afforded to the States whether by way of loans or grants or devolution of revenues in order to enable them both to balance their normal budgets and to fulfil the prescribed targets of the plan. The Administrative Reforms Commission has rightly frowned upon the system of tied and matching plan grants. It has recommended the abolition of the matching system which results in a 'distortion of priorities' of plan schemes of the States and 'erosion of their initiative' in the determination of plan programmes according to their own assessment of local needs and capacities. The Commission has also proposed that while a certain proportion of grant assistance should continue to be tied to schemes of basic national importance, the States should be free to spend the remainder on approved schemes in whatever priorities they may choose to adopt. In other words,

reappropriation of untied Plan grants within the range of schemes approved by the National Development Council should be permitted. Two points need emphasis here : one, that the proportion of discretionary grants should be reduced to a bare minimum necessary for Central authorities to make marginal adjustments ; second, that it will promote greater initiative on the part of States and reduce the possibility of Union-State friction if the allocation of the bulk of untied grants is made on the recommendations of the Finance Commission and not on those of the Planning Commission. Experience has shown that the States have more confidence in the impartiality of the Finance Commission than in that of the Planning Commission. Indeed, some Chief Ministers have advocated such a widening of the Finance Commission's functions as would make it an arbiter of financial allocations as between the Centre and the States, financial adviser to the Centre and States and monitor of the States' spending programmes. No Finance Commission would be able to bear the onus of such a multiple role. Another suggestion that could now be profitably implemented is that instead of being constituted at varying intervals, the Finance Commission should be made a standing body like the Commonwealth Grants Commission of Australia. In the altered political pattern in India, it would be useful, further, if a convention is evolved whereby the Finance Commission's recommendations are invariably treated as awards. At present the Union Government can and does turn down some of the recommendations of the Commission. The acceptance and implementation of the various suggestions mentioned above will enable the Finance Commission to act more effectively than hitherto as, what Asok Chanda has aptly called, 'a catalyst to bring about financial harmony between the Centre and the States'.

APPENDIX I

THE FIFTH FINANCE COMMISSION

(Appointment and Terms of Reference)

The following is the text of the Presidential Order setting up the fifth Finance Commission :

In pursuance of the provisions of Article 280 of the Constitution of India and the Finance Commission (Miscellaneous Provisions) Act, 1951 (33 of 1951), the President is pleased to constitute with effect from March 15, 1968, a Finance Commission consisting of Mr. Mahavir Tyagi, former Union Minister of Rehabilitation, as the Chairman and the following four other members : Mr. P. C. Bhattacharya, Former Governor, Reserve Bank of India, Mr. M. Seshachalpathy, retired judge, Andhra Pradesh High Court, Dr. D. T. Lakdawala, Professor, Department of Economics, Bombay University, and Mr. V. L. Gidwani, former Chief Secretary, Government of Gujarat, Member-Secretary.

The members of the Commission shall hold office until July 31, 1969. Mr. Mahavir Tyagi shall render part-time service as Chairman of the Commission until such date as the Central Government may specify in this behalf and, thereafter, he shall render whole-time service as Chairman of the Commission. Of the other members, Mr. P. C. Bhattacharya shall render part-time service as member of the Commission until such date as the Central Government may specify in this behalf and thereafter, he shall render whole-time service as member of the Commission. The other three members will render whole-time service.

The Commission shall make recommendations as to the following matters :

(*a*) The distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter I of part XII of the Constitution and the allocation between the States of the respective shares of such proceeds ;

(*b*) The principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and

the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under Article 275 for purposes other than those specified in the provisions to clause (1) of that article and other than the requirement of the Five-year Plan, having regard, among other considerations, to—(1) The revenue resources of those States for the five years ending with the financial year 1973–74 on the basis of the levels of taxation likely to be reached at the end of the financial year 1968–69; (2) The requirements on the revenue account of those States to meet the expenditure on administration, interest charges in respect of their debt, maintenance and upkeep of Plan schemes completed by the end of 1968–69, transfer of funds to local bodies and aided institutions and other committed expenditure; (3) The scope for better fiscal management as also for economy consistent with efficiency which may be effected by the States in their administrative, maintenance, developmental and other expenditure;

(*c*) The changes, if any, to be made in the principles governing the distribution among the States of the grant to be made available to the States in lieu of the repealed tax on railway passenger fares;

(*d*) The changes, if any, to be made in the principles governing the distribution among the States under Article 269 of the net proceeds in any financial year of estate duty in respect of property other than agricultural land;

(*e*) The desirability or otherwise of maintaining the existing arrangements under the additional duties of Excise (goods of special importance) Act, 1957, in regard to the levy of additional duties of excise on sugar, textiles and tobacco in lieu of the States' sales taxes thereon, with or without any modifications, and the scope for extending such arrangements to other items or commodities;

(*f*) Irrespective of the recommendations made under item (*e*) above, the changes, if any, to be made in the principles governing the distribution of the net proceeds in any financial year of the additional excise duties leviable under the 1957 Act aforesaid on each of the following commodities: (*i*) cotton fabrics, (*ii*) silk fabrics, (*iii*) woollen fabrics, (*iv*) rayon or artificial silk fabrics, (*v*) sugar, and (*vi*) tobacco including manufactured tobacco in replacement of the States' sales taxes formerly levied by the State Governments,

provided that the share accruing to each State shall not be less than the revenue realised from the levy of the sales tax for the financial year 1956–57 in that State ;

(*g*) The principles which should govern the distribution of the net proceeds of such additional items or commodities as may be recommended under item (*e*) above for levy of additional excise duties in lieu of the States' sales taxes thereon ;

(*h*) The scope for raising revenue from the taxes and duties mentioned in Article 269 of the Constitution but not levied at present ;

(*i*) The scope for raising additional revenue by the various State Governments from the sources of revenue available to them ; and

(*j*) The problem of unauthorised overdrafts of certain States with the Reserve Bank and the procedure to be observed for avoiding such overdrafts.

The Commission in making its recommendations on the various matters aforesaid shall have regard to the resources of the Central Government and defence and border security, debt servicing and other committed expenditure or liabilities.

The Commission shall make an interim report by September 30, 1968, covering as many of the matters mentioned in para 4 above as possible and, in particular, in respect of the financial year 1969–70 ; and make the final report by July 31, 1969 on each of the said matters and covering a period of five years commencing from April 1, 1969, indicating in its reports the basis on which it has arrived at its findings and making available the relevant documents.

APPENDIX II

ARTICLES OF THE CONSTITUTION RELATING TO UNION-STATE FINANCIAL RELATIONS AND THE FINANCE COMMISSION

268. (1) Such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List shall be levied by the Government of India but shall be collected :

(*a*) in the case where such duties are leviable within any Union territory by the Government of India, and

(*b*) in other cases, by the States within which such duties are respectively leviable.

(2) The proceeds in any financial year of any such duty leviable within any State shall not form part of the Consolidated Fund of India, but shall be assigned to that State.

269. (1) The following duties and taxes shall be levied and collected by the Government of India but shall be assigned to the States in the manner provided in clause (2), namely :

(*a*) duties in respect of succession to property other than agricultural land ;

(*b*) estate duty in respect of property other than agricultural land ;

(*c*) terminal taxes on goods or passengers carried by railway, sea or air ;

(*d*) taxes on railway fares and freights ;

(*e*) taxes other than stamp duties on transactions in stock-exchanges and future markets ;

(*f*) taxes on the sale or purchase of newspapers and on advertisements published therein ;

(*g*) taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.

(2) The net proceeds in any financial year of any such duty tax, except in so far as those proceeds represent proceeds attributable to Union territories, shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that duty or tax is leviable in that year, and shall be distributed among those States in accordance with such principles of distribution as may be formulated by Parliament by law.

(3) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in the course of inter-State trade or commerce.

270. (1) Taxes on income other than agricultural income shall be levied and collected by the Government of India and distributed between the Union and the States in the manner provided in clause (2).

(2) Such percentage, as may be prescribed, of the net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments, shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that tax is leviable in that year, and shall be distributed among those States in such manner and from such times as may be prescribed.

(3) For the purposes of clause (2), in each financial year such percentage as may be prescribed of so much of the net proceeds of taxes on income as does not represent the net proceeds of taxes payable in respect of Union emoluments shall be deemed to represent proceeds attributable to Union territories.

(4) In this Article :

(*a*) 'taxes on income' does not include a corporation tax;

(*b*) 'prescribed' means :

(*i*) until a Finance Commission has been constituted prescribed by the President by order, and

(*ii*) after a Finance Commission has been constituted, prescribed by the President by order after considering the recommendations of the Finance Commission ;

(*c*) 'Union emoluments' includes all emoluments and pensions payable out of the Consolidated Fund of

India in respect of which income tax is chargeable.

271. Notwithstanding anything in Articles 269 and 270 Parliament may at any time increase any of the duties or taxes referred to in those Articles by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part of the Consolidated Fund of India.

272. Union duties of excise other than such duties of excise on medicinal and toilet preparations as are mentioned in the Union List shall be levied and collected by the Government of India, but, if Parliament by law so provides, there shall be paid out of the Consolidated Fund of India to the States to which the law imposing the duty extends sums equivalent to the whole or any part of the net proceeds of that duty, and those sums shall be distributed among those States in accordance with such principles of distribution as may be formulated by such law.

273. (1) There shall be charged on the Consolidated Fund of India in each year as grants-in-aid of the revenues of the States of Assam, Bihar, Orissa and West Bengal, in lieu of assignment of any share of the net proceeds in each year of export duty on jute and jute products to those States, such sums as may be prescribed.

(2) The sums so prescribed shall continue to be charged on the Consolidated Fund of India so long as any export duty on jute or jute products continues to be levied by the Government of India or until the expiration of ten years from the commencement of this Constitution whichever is earlier.

(3) In this Article the expression 'prescribed' has the same meaning as in Article 270.

274. (1) No Bill or amendment which imposes or varies any tax or duty in which States are interested, or which varies the meaning of the expression 'agricultural income' as defined for the purposes of the enactments relating to Indian income tax, or which affects the principles on which under any of the foregoing provisions of this Chapter moneys are or may be distributable to States, or which imposes any such surcharge for purposes of the Union as is mentioned in the foregoing provisions of this Chapter, shall be introduced or moved in either House of Parliament except on the recommendation of the President.

(2) In this Article, the expression 'tax or duty in which States

are interested' means—

(*a*) a tax or duty the whole or part of the net proceeds whereof are assigned to any State ; or

(*b*) a tax or duty by reference to the net proceeds whereof sums are for the time being payable out of the Consolidated Fund of India to any State.

275. (1) Such sums as Parliament may by law provide shall be charged on the Consolidated Fund of India in each year as grants-in-aid of the revenues of such States as Parliament may determine to be in need of assistance, and different sums may be fixed for different States :

Provided that there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of a State to meet the costs of such schemes of development as may be undertaken by the State with the approval of the Government of India for the purpose of promoting the welfare of the Scheduled Tribes in that State or raising the level of administration of the Scheduled Areas therein to that of the administration of the rest of the areas of that State :

Provided further that there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of the State of Assam sums, capital and recurring, equivalent to :

(*a*) the average excess of expenditure over the revenues during the two years immediately preceding the commencement of this Constitution in respect of the administration of the tribal areas specified in Part A of the table appended to paragraph 20 of the Sixth Schedule ; and

(*b*) the costs of such schemes of development as may be undertaken by that State with the approval of the Government of India for the purpose of raising the level of administration of the said areas to that of the administration of the rest of the areas of that State.

(2) Until provision is made by Parliament under clause (1) the powers conferred on Parliament under that clause shall be exercisable by the President by order and any order made by the President under this clause shall have effect subject to any provision so made by Parliament :

Provided that after a Finance Commission has been constituted no order shall be made under this clause by the President except after

considering the recommendations of the Finance Commission.

276. (1) Notwithstanding anything in Article 246, no law of the Legislature of a State relating to taxes for the benefit of the State or of a municipality, district board, local board or other local authority therein in respect of professions, trades, callings or employments shall be invalid on the ground that it relates to a tax on income.

(2) The total amount payable in respect of any one person to the State or to any one municipality, district board, local board or other local authority in the State by way of taxes on professsions, trades, callings and employments shall not exceed two hundred and fifty rupees per annum :

Provided that if in the financial year immediately preceding the commencement of this Constitution there was force in the case of any State or any such municipality, board or authority a tax on professions, trades, callings or employments the rate, or the maximum rate, of which exceeded two hundred and fifty rupees per annum, such tax may continue to be levied until provision to the contrary is made by Parliament by law, and any law so made by Parliament may be made either generally or in relation to any specified States, municipalities, boards or authorities.

(3) The power of the Legislature of a State to make laws as aforesaid with respect to taxes on professions, trades, callings and employments shall not be construed as limiting in any way the power of Parliament to make laws with respect to taxes on incomes accruing from or arising out of professions, trades, callings and employments.

277. Any taxes, duties, cesses or fees which immediately before the commencement of this Constitution, were being lawfully levied by the Government of any State or by any municipality or other local authority or body for the purposes of the State, municipality, district or other local area may, notwithstanding that those taxes, duties, cesses or fees are mentioned in the Union List, continue to be levied and to be applied to the same purposes until provision to the contrary is made by Parliament by law.

279. (1) In the foregoing provisions of this Chapter, 'net proceeds' means in relation to any tax or duty the proceeds thereof reduced by the cost of collection, and for the purposes of those

provisions the net proceeds of any tax or duty, or of any part of any tax or duty, in or attributable to any area shall be ascertained and certified by the Comptroller and Auditor-General of India, whose certificate shall be final.

(2) Subject as afosesaid, and to any other express provision of this Chapter, a law made by Parliament or an order of the President may, in any case where under this Part the proceeds of any duty or tax are, or may be assigned to any State, provide for the manner in which the proceeds are to be calculated, for the time from or at which and the manner in which any payments are to be made, for the making of adjustments between one financial year and another, and for any other incidental or ancillary matters.

280. (1) The President shall, within two years from the commencement of this Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission which shall consist of a Chairman and four other members to be appointed by the President.

(2) Parliament may by law determine the qualifications which shall be requisite for appointment as members of the Commission and the manner in which they shall be selected.

(3) It shall be the duty of the Commission to make recommendations to the President as to :

(*a*) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under this Chapter and the allocation between the States of the respective share of such proceeds ;

(*b*) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India ;

(*c*) any other matter referred to the Commission by the President in the interests of sound finance.

(4) The Commission shall determine their procedure and shall have such powers in the performance of their functions as Parliament may by law confer on them.

281. The President shall cause every recommendation made by the Finance Commission under the provisions of this Constitution

together with an explanatory memorandum as to the action taken thereon to be laid before each House of Parliament.

MISCELLANEOUS FINANCIAL PROVISIONS

282. The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws.

286. (1) The property of the Union shall, save in so far as Parliament may by law otherwise provide, be exempt from all taxes imposed by a State or by any authority within a State.

(2) Nothing in clause (1) shall, until Parliament by Law otherwise provides, prevent any authority within a State from levying any tax on any property of the Union to which such property was immediately before the commencement of this Constitution liable or treated as liable, so long as that tax continues to be levied in that State.

287. (1) No law of a State shall impose, or authorize the imposition of, a tax on the sale or purchase of goods where such sale or purchase takes place :

(*a*) outside the State ; or

(*b*) in the course of the import of the goods into, or export of the goods out of, the territory of India.

(2) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in any of the ways mentioned in clause (1).

(3) Any law of a State shall, in so far as it imposes, or authorizes the imposition of, a tax on the sale or purchase of goods declared by Parliament by law to be of special importance in inter-State trade or commerce, be subject to such restrictions and conditions in regard to the system of levy, rates and other incidents of the tax as Parliament may by law specify.

287. Save in so far as Parliament may by law otherwise provide, no law of a State shall impose, or authorize the imposition of, a tax on the consumption or sale of electricity (whether produced by a Government or other persons) which is :

(*a*) consumed by the Government of India, or sold to the Government of India for consumption by that Govern-

ment ; or

(*b*) consumed in the construction, maintenance or operation of any Railway by the Government of India or a railway company operating that railway, or sold to that Government or any such railway company for consumption in the construction, maintenance or operation of any railway,

and any such law imposing, or authorizing the imposition of, a tax on the sale of electricity shall secure that the price of electricity sold to the Government of India for consumption by that Government, or to any such railway company as aforesaid for consumption in the construction, maintenance or operation of any railway, shall be less by the amount of the tax than the price charged to other consumers of a substantial quantity of electricity.

288. (1) Save in so far as the President may by order otherwise provide, no law of a State in force immediately before the commencement of the Constitution shall impose, or authorize the imposition of, a tax in respect of any water or electricity stored, generated, consumed, distributed or sold by any authority established by any existing law or any law made by Parliament for regulating or developing any inter-State river or river valley.

Explanation—The expression 'law of a State in force' in this clause shall include a law of a State passed or made before the commencement of this Constitution and not previously repealed, notwithstanding that it or parts of it may not be then in operation either at all or in particular areas.

(2) The Legislature of a State may by law impose, or authorize the imposition of, any such tax as is mentioned in clause (1), but no such law shall have effect unless it has, after having been reserved for the consideration of the President, received his assent ; and if any such law provides for the fixation of the rates and other incidents of such tax by means of rules or orders to be made under the law by any authority, the law shall provide for the previous consent of the President being obtained to the making of any such rule or order.

289. (1) The property and income of a State shall be exempt from Union taxation.

(2) Nothing in clause (1) shall prevent the Union from impos-

ing, or authorizing the imposition of, any tax to such extent, if any, as Parliament may by law provide in respect of a trade or business of any kind carried on by or on behalf of, the Government of a State, or any operations connected therewith, or any property used or occupied for the purposes of such trade or business or any income accruing or arising in connection therewith.

(3) Nothing in clause (2) shall apply to any trade or business, or to any class of trade or business, which Parliament may by law declare to be incidental to the ordinary functions of government.

BORROWING

292. The executive power of the Union extends to borrowing upon the security of the Consolidated Fund of India within such limits, if any, as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed.

293. (1) Subject to the provisions of this Article, the executive power of a State extends to borrowing within the territory of India upon the security of the Consolidated Fund of the State within such limits, if any, as may from time to time be fixed by the Legislature of such State by law and to the giving of guarantees within such limits, if any, as may be so fixed.

(2) The Government of India may, subject to such conditions as may be laid down by or under any law made by Parliament, make loans to any State or, so long as any limits fixed under Article 292 are not exceeded, give guarantees in respect of loans raised by any State, and any sums required for the purpose of making such loans shall be charged on the Consolidated Fund of India.

(3) A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government, or in respect of which a guarantee has been given by the Government of India or by its predecessor Government.

(4) A consent under clause (3) may be granted subject to such conditions, if any, as the Government of India may think fit to impose.

EMERGENCY PROVISIONS

354. (1) The President may, while a Proclamation of Emergency is in operation, by order direct that all or any of the provisions of articles 268 to 279 shall for such period, not extending in any case beyond the expiration of the financial year in which such Proclamation ceases to operate, as may be specified in the order, have effect subject to such exceptions or modifications as he thinks fit.

360. (1) If the President is satisfied that a situation has arisen whereby the financial stability or credit of India or of any part of the territory thereof is threatened, he may by a Proclamation make a declaration to that effect.

(2).........

(3) During the period any such Proclamation as is mentioned in clause (1) is in operation, the executive authority of the Union shall extend to the giving of directions to any State to observe such canons of financial propriety as may be specified in the directions, and to the giving of such other directions as the President may deem necessary and adequate for the purpose.

(4) Notwithstanding anything in this Constitution—

(*a*) any such direction may include—

(*i*) a provision requiring the reduction of salaries and allowances of all or any class of persons serving in connection with the affairs of a State;

(*ii*) a provision requiring all Money Bills or other Bills to which the provisions of article 207 apply to be reserved for the consideration of the President after they are passed by the Legislature of the State;

(*b*) it shall be competent for the President during the period any Proclamation issued under this article is in operation to issue directions for the reduction of salaries and allowances of all or any class of persons serving in connection with the affairs of the Union including Judges of the Supreme Court and the High Courts.

BIBLIOGRAPHY

(A) ORIGINAL SOURCES

1. Financial Resolution No. 1514 dated 8 July 1873.
2. Report of the Royal Commission Upon Decentralisation, 1909.
3. Report on Indian Constitutional Reforms, 1918.
4. The Government of India Act, 1919.
5. Local Governments (Borrowing) Rules, 1920.
6. Government of India Act, 1935.
7. Constituent Assembly Debates, 12 Vols., 1947–50.
8. Report of the Indian States Finances Enquiry Committee, 1948–49.
9. The Constitution of India.
10. Report of the Taxation Enquiry Commission, 1953–54, 1955.
11. Paul H. Appleby, *Public Administration in India*, Report of a Survey, 1963.
12. Report of the First Finance Commission, 1952.
13. Report of the Second Finance Commission, 1957.
14. Report of the Third Finance Commission, 1961.
15. Report of the Fourth Finance Commission, 1965.
16. Administrative Reforms Commission, *Report on the Machinery of Planning*, 1968.

(B) SECONDARY SOURCES—BOOKS

1. Agarwal, P. P., *The System of Grants-in-aid in India*, Bombay, 1959.
2. Aiyar, S. P., *Federalism and Social Change*, Bombay, 1961.
3. Alexandrowics, C. H., *Constitutional Developments in India*, Madras, 1957.
4. Ambedkar, B. R., *The Evolution of Provincial Finance in India*, Lahore, 1925.
5. Austin, Granville, *The Indian Constitution : Cornerstone of A Nation*, London, 1966.
6. Banerji, P., *Provincial Finance in India*, Calcutta, 1929.

7. Basu, D. D., *Commentary on the Constitution of India*, 5 Vols., Calcutta, 1963–65.
8. Bombwall, K. R., *The Foundations of Indian Federalism*, Bombay, 1967.
9. Bhargava, R. N., *The Theory and Practice of Union Finance in India*, London, 1956.
10. Birch, A. H., *Federalism, Finance and Social Legislation*, London, 1955.
11. Brady, Alexander, *Democracy in the Dominions*, Toronto, 1948.
12. Chand, Gyan, *The Essentials of Federal Finance*, Bombay, 1930.
13. Chanda, Asok, *Federalism in India*, London, 1965.
14. Chintamani, C. Y., and M. R. Masani, *India's Constitution at Work*, Madras, 1940.
15. Coondoo, R., *The Division of Powers in the Indian Constitution*, Calcutta, 1965.
16. Dawson, R. M., *Democratic Government in Canada*, Toronto, 1949.
17. Friedrich, Carl, and Robert R. Bowie (Eds.), *Studies in Federalism*, Boston, 1954.
18. Gadgil, D. R., *Planning and Economic Policy in India*, Bombay, 1965.
19. Ganguli, B. N., 'Federal-State Financial Relations in U.S.A., Canada and Australia and their Lessons for India" in Sovani, Y. N., and V. M. Dandekar (Eds.), *Changing India*, Bombay, 1961.
20. Hanson, A. H., *The Planning Process*, London, 1966.
21. Haqqi, S. A. H., *Union-State Relations in India*, Meerut, 1967.
22. Krishnamurty, A., *The Indian Union and the States*, London, 1965.
23. Lakdawala, D. T., *Union-State Financial Relations*, Bombay, 1967.
24. Macmahon, Arthur W., *Delegation and Autonomy*, Bombay, 1961.
25. Misra, B .R., *Economic Aspects of the Indian Constitution*, Calcutta, 1958.
26. Misra, B. R., *Indian Federal Finance*, Calcutta, 1960.

27. Morris-Jones, W. H., *Parliament in India*, London, 1957.
28. Morris-Jones, W. H., *Government and Politics of India*, London, 1964.
29. Panikkar, K. M., *The Foundations of New India*, London, 1963.
30. Venkataraman, K., *State Finances in India, A Perspective Study for the Plan Periods, 1950–64*, Bombay, 1968.
31. Prasad, Bisheshwar, *The Origins of Provincial Autonomy*, Allahabad, 1946.
32. Pylee, M. V., *Constitutional Government in India*, Bombay, 1965.
33. Rao, K. V., *Parliamentary Democracy of India*, Calcutta, 1965.
34. Rau, B.N., *The Making of the Indian Constitution*, Madras, 1960.
35. Ray, Amal, *Inter-Governmental Relations in India*, Bombay, 1966.
36. Santhanam, K., *Union-State Relations in India*, Bombay, 1960.
37. Sastri, K. V. S., *Federal-State Fiscal Relations in India*, Bombay, 1966.
38. Sawer, Geoffrey (Ed.), *Federalism, An Australian Jubilee Study*, Melbourne, 1955.
39. Strachey, Sir John and Lieut. Gen. Richard, *Finances and Public Works in India*, 1869–1881, London, 1882.
40. Vakil, C. N., and H. M. Patel, *Finances Under Provincial Autonomy*, Bombay, 1940.
41. Wheare, K. C., *Federal Government*, London, 1956.

INDEX